# THE CARIBBEAN BASIN INITIATIVE: A WELCOME REMEDY TO THE IRONIC TURMOIL

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Without risk of being charged with using hyperbole, it can be said that a catastrophe of immense proportions is unfolding in Central America: In El Salvador, output has already fallen by 20 percent; it will continue to fall. People are killing each other indiscriminately; terrorists are blowing bridges' electric generation and threatening to murder those who participate in the elections. The middle class, including the petty bourgeois and the small- and medium-sized farmer and businessman, cannot get credit. They cannot borrow dollars; they have to prepay letters of credit. Given the nature of the economy—small, open, dependent—almost all output has some foreign input. Therefore, dollars are essential to production. Illiquidity threatens the survival of the middle class in Central America.

## I. Economic Strain: The Middle Class Revolutionaries

We frequently talk about peasants and revolution, but in the past 150 years the middle class has been the key factor in revolution. The middle class provides for economic expansion and development. At the same time the middle class imposes a fragility on the economy as a result of the effects of the people's changing attitudes about the future. In modern economies the broadly defined middle class extends legitimacy to governments. Because of its latent power and fragility, it is the revolutionary class. The threat of destruction looms over the new middle class in Central America.

In many respects, the economic situation in Costa Rica is even more grave than in El Salvador. To the extent that a country can be bankrupt, Costa Rica is bankrupt. Costa Rica has stopped paying most of its bills. Of course, government bills are the first to be paid, so there is little left over for the private sector. Gross domes-

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tic product (GDP) is falling; inflation is heading towards three digits.

In the Dominican Republic, after a decade of strong growth, the current account deficit is approaching $1 billion. Dominicans will have to tighten their belts. Honduras, weakened by the world situation, with political fears spilling over from its neighbors, also finds it difficult to borrow. Even those economies that are usually stable and strong are severely strained. The following considerations are likely contributories to the growing economic strain.

For instance, the price of coffee fell from three dollars to almost a dollar. El Salvador is two-thirds dependent upon coffee exports. Given the size of coffee in its GDP, such a decline would be equivalent to eliminating all United States export earnings. Similarly, in Santa Domingo sugar decreased from 40 cents to 12 cents. A farm bill[1] is about to be passed that will drive sugar prices down even further.

Consider the price of oil. Oil has gone from $2 a barrel to over $30 a barrel. The price increase has affected all of us. Moreover, along with many other factors, oil prices have driven interest rates to record levels. The increase in the price of oil swept across the world like a hurricane, destroying the world's productive stock. The world must replace its goods with more energy-efficient capital, and new energy sources must be found.

All of these events have had their impact throughout the world. However, the effects on Central America and the Caribbean have been severe. In part, this severity is due to our perception; these are our neighbors. Therefore, perhaps we are more sensitive to their problems because their problems affect us. Partially, the severity is due to the brittleness of the political institutions. It may also be attributed to social problems and economic factors which are addressed herein. These problems help explain what this Administration is trying to do in the Caribbean Basin.

The marvelous thing about time is that it keeps everything from happening at once. But it has its disadvantages; we can only speak linearly—one word at a time. If we focus on social problems, others find the focus too narrow or simplistic. A political focus might be found unsatisfactory because it may lack consideration of the economic dimensions. The economic focus herein will be found by some to be unsatisfactory because it seems to ignore for-

1. Agriculture and Food Act of 1981, Pub. L. No. 97-98, § 901, 95 Stat. 1213, 1257 (1981).

eign trained and controlled terrorists, and long standing social and political problems.

All of these things are simultaneously pertinent but cannot be analyzed and communicated at the same time. The Administration has put together a policy that attempts to address all of these problems. However, the Administration has to sell it by speaking linearly—one word at a time.

## II. POLICY: OPEN V. CLOSED

Let us take a look at some of the policies that these various countries have adopted. The Caribbean countries are small, and size matters. Adam Smith said that the degree of specialization is determined by the size of the market. This fundamental economic axiom is largely irrelevant to economies totally integrated into the world economy. But when countries attempt to avoid openness, this basic truism becomes overriding (just as it would if Wyoming tried to become economically independent from the rest of the United States).

Many of the countries of the Basin attempted to avoid exposure to the world's economy. They adopted policies called import substitution.[2] If the country were importing television sets, tools, shovels, machetes and toothpaste, and exporting rice, coffee, sugar and bauxite, import substitution policies would aim at encouraging local manufacture of these imports, hopefully without affecting basic exports.

### *A. Seeking Independence via Industrialization*

Countries adopted policies in order to industrialize, diversify, modernize and, thereby, gain greater independence from industrialized countries. To bring about import substitution, all that was needed was high protection against imports and subsidized interest and exchange rates (frequently overvalued). Tariff protection was set up to further the goal of economic independence.

We have had fairly high tariffs at various times in our history, but there is a difference here. The following is a hypothetical example: Consider a 100 percent tariff on an item produced locally from imported parts, capital and some raw material. Since these

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2. For a critical discussion of import substitution, see T. MORGAN, ECONOMIC DEVELOPMENT: CONCEPT AND STRATEGY 324-25 (1975); for a discussion of the impact of import substitution policies, see A. KRUEGER, LIBERALIZATION ATTEMPTS & CONSEQUENCES (1978).

are small countries, unless the product is agricultural, chances are that the value added[3] locally will be quite small. If, for example, the value added locally were only 10 percent and there was a 100 percent tariff on the product and 0 percent tariff on its inputs, the average tariff level would not be high. Notice that 100 percent of the whole value applied to the 10 percent added locally is a 1,000 percent level of protection of local production.

Such a level of protection, not unusual in these small economies, acts like a black hole sucking resources into protected industries. As a result, resources are sucked out of agriculture and export industries (the rural area), and into protected industries. With a 1000 percent effective protection, producers can relax and use whatever technology is readily available, whether appropriate or not. Technology from capital-rich, labor-scarce economies was brought into use in these capital-scarce, unskilled labor-abundant economies. Fairly rapid growth resulted throughout the area: there was an increase in the demand for labor (though higher skilled than was available), real wages rose and demand for capital rose. In addition, foreign investment arrived rapidly and abundantly, and the foreign debt went up.

These policies led to growth in many countries, broke the back of traditional societies and created a belief in development. A different attitude towards the future emerged. But there were problems too. Because of the very high levels of protection, goods' prices rose and there was a small degree of inflation. Wages went up in labor markets. However, employment grew relatively slowly due to the imported machinery which required relatively little labor per machine. Since countries were producing at higher costs, locally manufactured inputs into agriculture (shovels, machetes, fertilizers) as well as other costs of production, such as transportation, rose. The first investments were in industries where markets were larger and the return was more attractive. Therefore, in the earlier years, the shift from agriculture to industry seemed unambiguously good. As the years passed, however, additional growth was achieved in increasingly inefficient industries. There was a catch in all of this.

3. "Value added is the difference between the price of purchased raw materials, semi-finished and finished parts, and services that are used to make a product and that product's final selling price." C. AMMER & D. AMMER, DICTIONARY OF BUSINESS AND ECONOMICS 440 (1977).

### *B. The Ironic Turnabout of Industrialization*

The catch was that due to the high costs of high levels of protection, very little of the new industrial output could be exported. Instead of gaining independence from having to import consumer and intermediate goods, countries merely shifted imports to different kinds of products (inputs, raw materials and capital goods). They became far more dependent on imports due to the fact that in small economies, even simple production requires imported input. The inevitable result was the development of a far more severe balance of payment constraint, and business cycles far deeper than in open, competitive economies.

Looking briefly at urban problems, we observe that traditional exports were largely agricultural commodities. As the exchange rate was allowed to become overvalued, and as input costs rose and capital was sucked out of agriculture, returns (both traditional and modern) to the rural sector fell. At the same time, new industries in the city generated high demand for skilled workers. Since skilled workers were in short supply, urban wages in the new industries which were given import protection rose sharply. Real wages in the rural and service sectors declined. Not suprisingly, rural-to-urban migration increased sharply. Wages were higher by several hundred percent in protected modern industry than on farms or in service industries in the city. Persons were willing to tolerate very high levels of unemployment because while the good jobs were very good, the bad jobs barely paid subsistence. Of course, the good jobs were never sufficiently abundant and unemployment remained high.

There was a similar process in capital markets. Interest rates were held artificially low. Governments did this partially to lower the cost of capital goods to induce rapid industrialization. There were also arguments (however false) that low interest rates would help small businessmen and farmers who could not afford the high interest rates which had resulted from the sharply rising demand for credit. The problem was that if credit were not allocated by interest rates, it would be allocated by some other criteria. If interest rates were held low, too many people would want to borrow and there would be insufficient credit. There would not be enough money to go around. What little there was would be soaked up by the largest and most influential investors (which are traditional families and protected sectors where risks are minimal). Small businessmen and farmers, unable to get credit, remain small. While the demagoguery asks that interest be kept artificially low so poor people can afford it, the reality is that small- and medium-sized businessmen and farmers are forced to borrow in exorbitantly high bank markets. Others are simply unable to obtain the credit they need to grow.

Consider the other side of the lending-borrowing equality. If borrowers are allowed to borrow at subsidized rates, savers must be paid less than the value of their savings. If savers cannot receive a decent return for holding money, they will not hold it. Those with access to foreign accounts will keep their money abroad which means that a nation's financial savings are not available to any but larger borrowers who have access to foreign credit. Small- and medium-sized entrepreneurs cannot keep their liquid assets abroad; nor can they borrow abroad. Therefore, they can neither save efficiently nor borrow at competitive rates. Again, to grow, any businessman or farmer must be able to save and borrow. The resulting economic growth tends to encourage trickling down, where the middle class grows from the top down, and the white- and blue-collar middle class grows more rapidly than the entrepreneurial middle class.

To summarize, countries sought greater independence from the industrialized west by substituting away from manufactured imports. Modernization resulted in a new white- and blue-collar middle class and rapid economic growth. At the same time, the countries developed an increased dependence on imports, falling rural income, rising urban unemployment, poor income distribution, constrained upward mobility for the entrepreneurial lower middle class, poor export performance, and controls throughout the economy. The end results were import controls, price controls, foreign exchange controls, and interest rate controls.

As this system matured, additional economic growth required higher levels of protection. The most promising industries were developed first, leaving less efficient industry and smaller markets for later development. Since little output could be exported, industrial expansion and employment growth depended on the internal market. Internal market growth depended upon investments in new industries whose markets were becoming less attractive. Therefore, the new industries required higher levels of subsidy and protection. The entire system was totally dependent upon the availability of foreign exchange, for while the new industries could generate no foreign exchange, they consumed vast quantities of it.

The effect on the foreign exchange markets can be appreciated by examining the effects on agriculture. Since exchange rates tended to be overvalued and credit scarce, even potentially efficient agriculture had difficulty exporting. Resources were sucked into import substitution industries rather than export industries. Economies became increasingly dependent upon their absolute advantages—tropical products and natural resources.

## III. WORLD MARKET CONTROL

The world tends to consume relatively steady amounts of the basic commodities. When there are bumper crops, prices fall; when there are poor world crops, prices rise. Basic commodities are bought and sold in world markets. Therefore, basic commodity exporting or importing countries have no control over prices paid or received. The result is that while these economies are building up their dependence on imports, they simultaneously build up their dependence on highly fluctuating earnings. Eventually, even during good times, because of the increasingly inefficient new industries in the import substitution industries, growth becomes relatively slower. During bad times, recessions become especially deep.

### *A. Effects of Price Fluctuation*

When increased oil prices, falling coffee and sugar prices, and rising interest rates hit these countries simultaneously, the results were catastrophic. The smaller and more internally oriented the economy, the more devastating the shock; the economies begin to break apart.

These problems are not easily solved because they require difficult adjustments. Adjustment requires some restructuring of the results of twenty years of institutional buildup. Foreign assistance is not enough to solve these problems. Unfortunately, internal policy reform is necessary but not entirely sufficient. Since development was originally spurred by the desire to industrialize, the problems have become identified as "western capitalist problems." The remedies, therefore, tend to come from left of center—*Dirigistas*.[4] We must, however, be very careful about labels. These are not market capitalist systems. They are highly controlled systems, often managed by traditional pre-capitalist classes.

4. The word *Dirigistas* in Spanish means those who seek to direct from above.

These systems, if we must label them, are more analogous to seventeenth and eighteenth century mercantilism: that long, dynamic period between feudalism and capitalism, when old wealth tried to perserve itself against the new middle class and its middle-class notions of economic and political freedom through parcelling out privilege and controlling the new commercial economy. Adam Smith recommended *laissez-faire* to rid the system of commercial monopolies, privilege and corruption of the old court.

### *B. Proposed Remedies*

Many of the remedies proposed for these economies seem similar to the liberal agenda in the United States. Therefore, many Americans are rather quick to identify with policies labeled as reformist in Central and South America, which include price controls, anti-foreign investment measures, subsidies, government controls on the private sector and nationalization. For example, observers quite correctly perceive that banks are instruments by which the wealthy use the nations' meager savings to finance their own ventures. The urge was to nationalize banks. The problem was that if interest rates were subsidized, there would be too little savings and too much demand for credit. If interest rates are not used to impersonally allocate savings, some other personal criteria will be used—family, corruption, political favor, ideological affinity or other similar criteria.

Nationalization will not change this reality. It can only be changed by impersonal market forces. Indeed, nationalization tends to quick-freeze the problem, thereby removing flexibility by politicizing change. Nationalization merely changes one set of non-market criteria for another. A similar process can be observed within the various types of controls that evolved in these systems. Import licenses, foreign exchange licenses and price rises were all subject to centralized personal or bureaucratic control rather than impersonal decentralized markets. Not suprisingly, this often led to relatively high levels of financial or political corruption.

Lincoln Steffens,[5] after many years of investigative journalism,

5. "Lincoln Steffens (1866-1936), born in San Francisco, graduated from the University of California (1889), studied abroad, and entered New York journalism (1892). He is best known for his leadership of the muckraking movement. As managing editor of *McClure's* magazine (1902-1906), and associate editor of the *American Magazine* and *Everybody's* (1906-1911), he was a contributor to the journalistic expose of business and government corruption. His articles were collected in THE SHAME OF THE CITIES (1904), THE STRUGGLE FOR SELF-GOVERNMENT (1906), and UPBUILDERS (1909). LINCOLN STEF-

concluded that the primary cause of corruption is opportunity. Opportunities for corruption are proportional to the degree of economic control exercised by men. Opportunities for corruption and preservation of privilege expand in what has become known as the reformist or populist systems—one more tragic irony of our day. Systems characterized by an abundance of direct, personally exercised control lead to intense political struggle over regulation of the instruments of control, adding a perverse set of incentives—patronage gone beserk—and allocation according to party and family affiliation rather than by impersonal market forces.

Conventional wisdom says exactly the reverse. Therefore, when systems come under strain, we often ask governments to become more directly involved. Governmental involvement tends to heighten political friction and weaken government institutions, exacerbating problems precisely at the wrong time.

It is nonsense to think of the turmoil throughout the region in capitalist revolutionary terms. Worse than nonsense, it is tragic because such an erroneous and simplistic approach casts terrorists as revolutionaries trying to rid the people of oppressive systems. Of course, Marxist terrorists are not revolutionaries. They have always opposed the only revolution worthy of the name, which is the movement towards greater individual freedom and opportunity. At best, the terrorists of any spectrum are twisted and dangerous individuals who wrap themselves in ideological jargon. At worst, they are tools of Cubans and Soviets. In either capacity, they are a threat to real progress.

## IV. BREAK DOWN OF TRADITIONAL SOCIETY OPENS DOORS TO REFORM

The turmoil in Central America is, in part, traditional society breaking down as a result of two decades of economic growth. It is also partially due to the middle class trying to break through the system of mercantilist privilege. In part, it is the breakdown of private institutions as the terms of trade reversal have caused the systems to be nonsustainable. The frustration of the urban unemployed, the political job market and the breakdown of public institutions further contribute to the turmoil. In some countries there is racism and cultural chauvinism which aggravate the situa-

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FENS SPEAKING (1936), is a posthumous collection of articles written during his later years. *See* J. HART, THE OXFORD COMPANION TO AMERICAN LITERATURE 800 (4th ed. 1965). *See generally* J. KAPLAN, LINCOLN STEFFENS: A BIOGRAPHY (1974).

tion. The tragic turmoil is not unlike periods in European history when the old order was giving slow birth to a modern, liberal system. There is a revolution going on and as the systems break apart, there is an opportunity to develop open, liberal systems.

If this revolution is interpreted in the socialist model coming out of the thirties, it will be tragic. Clearly, more control in the form of socialism is the wrong medicine and could prove disastrous. Government controls make economies rigid and either assure the preservation of privilege or move toward totalitarianism. Attempts to impose more control on systems trying to break through to openness and liberalism risk causing a collapse of these systems.

Political and economic liberalism and openness make systems flexible. Changes are allowed to occur through millions of individual decisions as individuals accommodate to new circumstances. Centralized systems, however, mean that governments must accommodate to change through explicit decisions that hurt some groups and help other groups. The result is that centralized and nonmarket systems resist change until it cannot be avoided; it then breaks through disruptively. The smaller the economy, the more this is apt to occur. The smaller economy is subject to external factors beyond its control and, therefore, demands more adjustments. Small economies must learn to float on the world's markets or they will be periodically broken apart.

## V. CONCLUSION

The foregoing technical sketches concerning tariffs, interest rates, patronage and privileges (as unpleasant as economic subjects are for most people) make the case that almost all conventional wisdom about the economies in South and Central America is false. With few exceptions, more open, competitive, market-oriented, liberal economic systems will foster growth, improve income distribution, and tend to depoliticize systems. Conventional wisdom dictates that these are capitalist systems needing socialism or New Deal reforms. Essentially, these are pre-capitalist, pre-democratic, mercantilist systems needing, above all, freedom and competition.

It is because of this framework that the Caribbean Basin Initiative is so heartily welcomed. It is an integrated program that in essence creates opportunities and incentives for liberal reform. The program provides emergency balance of payments support to weather the current financial crises and incentives for foreign investment so that a turnaround might occur more rapidly.

The Administration will propose to boldly open United States markets. Access to our giant market creates opportunities for these tiny economies that can be exploited fully only by systems that are more open and competitive. In one stroke, without having to preach or dictate, we will have created the strongest possible incentive for liberalization and reform. We will have opened a window onto the kind of future the citizens in the Caribbean Basin might enjoy. We will have raised both the rewards to sound economic policy and the costs of unsound policy. We will have raised the benefits of open, western-oriented systems, and the cost of closed hostile systems. We will have done this in a way that allows citizens of the Basin abundant choices.

In putting this program together, the Administration consulted intensively—jointly and bilaterally—with governments and private sector groups throughout the region and found that they perceived their problems very much as the Administration had. The utter disastrousness that has developed out of the situation has opened the door to greater understanding. Moreover, the disastrous results of closed systems and attempts at socialism in the Hemisphere have prepared the way for a break into liberal systems.

Our intense consultations convinced us that only with bold action could we hope to reverse the unfolding disaster. The situation demands a sweeping policy that offers a very stark contrast with the past or present in order to serve as a catalyst to other donors to up their ante, and to the citizens of the Basin to renew their faith in their own future. When the President announced the Caribbean Basin Initiative early this year, it was evident that the Administration had succeeded in putting together a program that is, in fact, bold enough to do just that.