



## MONTHLY BREAKFAST ANNOUNCEMENT

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Martin V. Alonzo

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Dear Colleague,

As countries in Latin America, Eastern Europe, and elsewhere move toward decentralized, market economies, the financial world is looking toward the privatization process, free trade agreements, and new investments in these countries for new opportunities.

This month the Global Economic Action Institute takes pleasure in presenting Bruce Claugus, Counsel to the firm of Townley & Updike, who will discuss these opportunities.

Mr. Claugus was educated at the University of Chicago and during the last twelve years has gained broad experience in Latin America, executing a wide variety of financings. Most recently this has included representing the borrowers and the guarantors in the privatization of the Cananea copper properties, financed through loans aggregating \$465,000,000. This transaction remains one of the largest privatizations completed anywhere in the world. Mr. Claugus is also now developing a series of innovative financings in Mexico and Argentina aggregating more than \$1 Billion.

Mr. Claugus will address the topic:

**"Financing the Industrialization of Emerging Economies"**

Details of the breakfast are as follows:

**DATE:** Thursday, September 26, 1991

**TIME:** 8:00 a.m. to 9:30 a.m.

**PLACE:** The Harvard Club, 27 West 44th Street

**COST:** \$25 payable by check in advance or at the door.

No registration fee for Corporate Members (please bring your Corporate Membership cards)

We encourage you to bring a colleague or, if you cannot attend, please feel free to send a representative. RSVP to Ms. Annette Thomas at (212) 370-0800 by the morning of Wednesday, September 25. We look forward to seeing you there.

Sincerely,

Martin V. Alonzo  
New York Chairman

"Financing the Industrialization of Emerging Economies"

Mr. Bruce Claugus  
Counsel, Townley & Updike

Date: Thursday, September 26, 1991  
Time: 8:00 a.m. to 9:30 a.m.  
Place: The Harvard Club, 27 West 44th Street

Attendees:

Carlos E. Alfaro, *Esq. Allende & Brea Inc.*  
Michael Ancona, *Vice President, Manufacturers Hanover Trust*  
Thomas Baba, *Economist, Toyota Motor Corporation*  
Theodore Berk, *President, T.G. Berk & Company*  
William B. Bierce, *Partner, Bierce & Kenerson*  
Theodore R. Britton Jr., *Ambassador & Director, Global Economic Action Institute*  
Ray Casanova, *Assistant Vice President, Metropolitan Life*  
John Clare, *Executive Vice President, Drover Technologies Inc.*  
Donald Culkin, *Senior Vice President, BFG Bank*  
Mario Diaz-Cruz, *Townley & Updike*  
Mose Durst, *Director, Global Economic Action Institute*  
William Edge, *Senior Vice President, Mase Westpac*  
James Fuller, *Senior Vice President, Bridge Information Systems*  
Linda Gerlach, *Student, Columbia University*  
Olga Gil, *President, Gil & Associates*  
Ann Heywood-Burton, *President, Ruth Hagy Broad Literary Agency*  
James Howell, *Manager, Global Economic Action Institute*  
Lillian Jasko, *Vice President, Banco Portugues do Atlantico*  
Frances Jay, *Associate, Manufacturers Hanover Trust*  
Hidemi Kawai, *Chief Representative, Export-Import Bank of Japan*  
Andres Kurrik, *Assistant Vice President, American Re-Insurance*  
Mimi Liebeskind, *Owner, Mimi Liebeskind Associates*  
Andrew A. Littauer, *Managing Director, Hilbert Peers & Young Inc.*  
Bella Luna, *Executive Secretary, Global Economic Action Institute*  
Olga Berde Mahl, *Esq. Equity Investors International*  
Harry Mahn, *Director, Teijin America Inc.*  
Barbara McAndrew, *Assistant Program Director, GALE, Global Economic Action Institute*  
Peter Merner, *President, Merner Research*  
Peter Mosse, *President, PJCM Corporation*  
Lakshmi Naganathan, *Former Ambassador to Sri Lanka*  
James O'Neill, *Senior Vice President, Rothchild Inc.*  
Rhonda Petsef, *Assistant Treasurer, Mitsui Trust & Banking Company*  
Luis C. Pi-Sunyer, *Kredietbank, New York Branch*  
Catherine Planet  
V. Richard Rabbito, *President, International Funding & Finance*  
William Repko, *Managing Director, Manufacturers Hanover Trust*

Kitaru Sato, *Senior Vice President, Marubeni America Corp*  
Moriyuki Sawamoto, *President, Research Institute of Construction & Economy*  
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Jeremiah Schnee, *Program Director GALE, Global Economic Action Institute*  
Mel Schumacher, *Senior Vice President & Assistant General Manager, Mitsui Taiyo Kobe Bank*  
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Daniel C. Steffens, *Associate, American Heritage Management Corp.*  
Rick Templeton, *President, INPID Group*  
Francesca Tripodi, *Research Assistant, Toyota Motor Corporation*  
Richard Ward, *Assistant Vice President, Mase Westpac*  
Krister Willgren, *Deputy Treasurer, Siemens Capital Corp.*  
Craig Wolson, *Vice President & Assistant General Counsel, Chemical Bank*  
Richard Wool, *Executive Vice President, T.G. Berk & Company Inc.*  
Roberta Yafie, *Knight Ridder Financial News*  
Yosuke Yasuda, *Vice President International Finance, Sanwa Bank*

**FINANCING THE INDUSTRIALIZATION OF THE EMERGING ECONOMIES**

An Address Sponsored by the  
Global Economic Action Institute  
Delivered by Bruce Claugus, Esq.  
Counsel to Townley & Updike

THE HARVARD CLUB  
New York, New York  
September 26, 1991

## **FINANCING THE INDUSTRIALIZATION OF THE EMERGING ECONOMIES**

An Address Sponsored by the  
Global Economic Action Institute  
Delivered by Bruce Claugus, Esq.  
Counsel to Townley & Updike

September 26, 1991

### **INTRODUCTION**

What a great time to be doing business in New York! The fundamentals really look good! It might be a little difficult to appreciate just how promising things are if you happen to have a lot of New York real estate in your portfolio, but I am convinced of the potential and, if I am right, we are in the early stages of a profound economic transformation. If this transformation is stable and economically useful, we are also at the beginning of a period during which the capital transfers and associated fees and income will make the flows of the 1980's look like petty cash.

### **THE POLITICAL AND ECONOMIC FOUNDATION**

The easiest way to analyze the situation is to contrast what the transformation is not with what it is. In a couple of months we will all be sitting down with our families and friends for Thanksgiving. Just three years ago, I was doing the same thing with several West German friends. This was Thanksgiving of 1988. Just a little earlier that year I had been to the IMF-World Bank meetings in Berlin and had visited the Berlin Wall. I had also visited the frontier at Hof, West Germany. There were no people at Hof so the sociological effects of this barrier were not so evident. The Wall seemed more like a mirage than a real

barrier at first, so I walked down from the road and touched it. It was chillingly real. I looked left and right and this Wall stretched on as far as I could see in both directions. It was a subduing experience. In Berlin it was worse. In Berlin there were people around. Every so often there would be a raised platform on which you could stand to look over the Wall. I climbed up to look and stood there with a lot of other people. The oppressive effect was really overpowering. So much so that the people there would huddle together and talk with one another in whispers.

So it was that I asked my German friends who joined me for Thanksgiving if they thought the Wall would ever come down. "No. Never. At least not in our lifetimes," they said. Two months later it was gone. Not many months later the Germans were effectively reunited despite the fact that a treaty existed declaring them separate and despite the fact that Soviet troops were stationed in East Germany to enforce that treaty.

It is easy and tempting to see this event as the collapse of Communism, especially since this particular interpretation has been emphasized by the events of last month. However, it is a manifestation of something much more profound. It reflects the operational failure and intellectual bankruptcy of the concept of the centralized economy. Terminology is unimportant. It does not matter whether the concept is embodied in or disguised by something called Communism, Socialism or State Capitalism, the concept is that of the centralized economy and

that concept has proved to be unworkable. What has not happened is the collapse of Communism. What has happened is the global collapse of centralized economies.

Of equal importance is the fact that this collapse has been brought about by the transcendent power of pluralistic, market economies managed by owners rather than bureaucrats. Hence you see not only the Soviet Union, Eastern Europe and Latin America decentralizing, but you also see the countries involved attempting to develop market economies. The phenomenon is a global transformation from centralized to market economies.

#### **THE STABILITY OF CURRENT TRENDS**

How stable is this transformation? If it is stable, economic plans can be based on it; if it is not, another basis must be sought for economic activity. I believe the transformation is stable and I base my opinion on the nature of free markets, the history of the transformation, the quality of current leadership, and the state of peace we enjoy.

#### **The Nature of Free Markets**

Free, pluralistic markets are a part of the natural state of man. The need for commercial freedom is the thread that runs through all economic development. A free market may be submerged from time to time, but it is very durable and inevitably reasserts itself. It is able to reassert itself because it succeeds.

From time to time man has tried to interfere with the free operation of the marketplace. Some of these attempts have

merely been foolish. In the modern era they have included tariffs, state monopolies, cartels and subsidies. Sometimes these attempts were also cruel. In all cases the result has been the same. Interference with a free market creates an economic pressure differential and this differential increases -- like water pressure building up behind a dam. For a while the barrier holds, but in the end the market sweeps it aside.

At the end of World War II, four men with enormous authority scratched their names on a treaty and dispatched armies to enforce it. The treaty drew a line across Europe and provided that on one side of the line markets would be free and the means of production would be controlled by private owners. On the other side, markets would be defined by decree and the means of production would be controlled by the state. Almost immediately an economic pressure differential began to develop and expressed itself in terms of haves and have nots. Eventually, the pressure differential increased beyond the capacity of the barrier and swept it away. Overnight! The same phenomenon has occurred in Chile, Mexico, Argentina, and Venezuela and is in process in Brazil and elsewhere. Juan Peron centralized the economy of Argentina to a degree unseen outside Communist countries. The result was a steady disintegration of the economy until 80% of the electorate now favors privatization and free trade. Now a Peronist is aggressively de-Peronizing Argentina.

## **The History of the Transformation**

Whereas the developments in Eastern Europe, the Soviet Union and Latin America have been spectacular, they were not the first nor the only such developments. The transformation has a much longer history. The same phenomenon occurred in the United Kingdom in the 1970's. The forces behind the Reagan administration and the LBO phenomenon of the 1980's were the need for political and economic decentralization. With these forces brewing in the liberal democracies, it should not be surprising to see it happening later and with more force in authoritarian settings. The more liberal the regime, the earlier and more peacefully the transformation has occurred. The point is that the trend toward market systems is a long term trend. The events in the Soviet Union, Eastern Europe and Latin America are the culmination, not the beginning, of the reemergence of market systems. Now that the barriers have come down, a more stable scenario prevails and should continue for the foreseeable future. It is much like the water rushing out from behind a broken dam. Once the artificial pressure differential has been relieved, the water flows more quietly and steadily.

## **The Quality of Current Leadership**

Until recently, with one or two exceptions, I did not see anything particularly special about recent leadership. To some extent I envied people who had lived in the presence of the great personalities of earlier this century. The Roosevelts,

Wilson, Churchill and others. But, considered more critically, it becomes apparent that, since World War II, the problems of leadership have been just as difficult and in many ways more threatening than in earlier days. I vividly remember Krushchev speaking at the United Nations, pounding his shoe on the desk, threatening to "bury" us. "Your grandchildren will grow up under Communism," he said. Dealing with the problems inherent in these threats has required astute leadership. In this context, you realize we also have been fortunate to have lived in the presence of great leaders. Thatcher, Reagan, Kohl, John Paul II, Walesa, Bush and Gorbachev -- Salinas, perhaps Menem, and others you might consider to be controversial. The recent leaders of the Western Democracies, John Paul II and Gorbachev have managed to transform the world and to bring about conditions so that for the first time in my life, the world is a safer place to live. The stable, relatively peaceful conditions we enjoy now make the mythical, global village a real possibility. Continuing good leadership from less rhetorical, but more managerial leaders like Bush, Major, Kohl and Gorbachev will keep these stable, relatively peaceful conditions in place so that we need not unduly fear disruption of the reemergent, pluralistic market systems. In fact, the stable political environment should strengthen and accelerate the establishment of these structures.

On the strength of the nature of market systems, long term liberal trends, and great leadership, centralized economies have collapsed and are being replaced by pluralistic, market

economies. We have peace and continuing good political management. I believe the new order is stable and should last into the foreseeable future. If it is stable, is it economically useful? What is specifically occurring economically and what does it mean for the capital markets? The process is that of decentralization and the development of market economies. With decentralization and a market economy, industrialization becomes possible. If that is the process and the possibility, what does it mean for us?

#### **PRIVATIZATION, FREE TRADE AND INDUSTRIALIZATION**

The process of decentralization and the development of market economies is, in its essence, mechanical and at least two, separate, mechanical steps are evident. The successful execution of these two steps permits industrialization. The most obvious mechanical step is that of the privatization now being undertaken.

#### **Privatization**

Roughly 50% of the Mexican economy and 80% of the Argentine economy is under governmental control and is subject to privatization. Essentially the entire economy of Eastern Europe is under the now reluctant control of the respective governments. Thousands of companies are involved. In Mexico, the most notable examples are the two airlines (privatized approximately twenty--eight months ago), the Cananea copper properties (privatized approximately six months ago), Telmex (winning bid announced last December), eighteen commercial banks (being privatized this

year), the steel industry (guidelines being formulated) and the secondary and tertiary petrochemical industry (formative stage). In Argentina, foreign investment rules are more liberal and every asset from the telephone company to the zoo is scheduled for privatization, the telephone company and the national airline being the most notable examples to date. Included are hundreds of companies owned by the Argentine military establishment. Commercial entities based in the United States are heavily involved in the process of privatization as operators, investors or sources of funding. Consequently, structuring and executing the transactions required to privatize these assets is an undertaking of enormous scope presenting unusual opportunities for the capital markets here in New York.

#### **Free Trade**

A less noticeable mechanical step is the rapid development of free trade agreements. Privatization moves previously governmental entities into the arena of the free market; free trade agreements make the market larger. They also have the effect of making the market more pluralistic by breaking up or preventing monopolistic or oligarchic systems. There is no point to replacing a public monopoly or oligarchy with a privately owned counterpart. The economic component of this process is the interest in forcing the revitalization of a stagnant economy and opening it to important domestic and foreign investment. This includes the interest in encouraging pluralism by discouraging monopoly or oligarchy.

There is also a significant political component. At least in Latin America, the ratification of a bilateral, free trade agreement is seen as rendering basic economic changes, such as privatization, permanent. Once governmental assets are privatized, a free trade agreement is in place and material foreign assets have been deployed in the country in question, renationalization is a much more questionable alternative to continued development of a free market economy. Fast track authority has been extended and free trade agreements are being negotiated now between the United States and Canada and Mexico and are planned between the United States and the signatories to Mercosur. These treaties are expected to reach final form soon - in the case of Mexico, before the presidential campaign begins here in the U.S. Eastern European countries are in some cases negotiating like arrangements with the EC and would interact with the United States through the Uruguay Round of trade negotiations.

The immediate commercial consequence of the emerging free trade agreements involving the United States is significantly increased activity involving companies taking strategic positions to capitalize on the opportunity offered by the expected free trade agreements and to protect themselves from intensified competition. Good examples of these treaty driven transactions are arrangements being contemplated by the Mexican investment banking industry.

Twenty-five investment banks are currently in business in Mexico. Once the free trade agreement between Mexico and the United States and Canada is in place and U.S. investment banks can begin unfettered operation in Mexico, it is inconceivable that all twenty-five will continue in operation. There will be a major consolidation of the industry. The executives of these concerns recognize this fact and are aggressively in the market seeking joint ventures with U.S. investment banks. The Mexican institutions propose to exchange existing Mexican investment banking infrastructures for U.S. technology and market power. The same initiatives are underway in other sectors of the Mexican economy and the same market activity can be observed. As in the case of privatization, commercial entities based in the United States are the best candidates for participation in this phenomenon, considering the technical prowess, market power, competitive threat and geographical proximity of these companies. The primary manifestation of this phenomenon will be strategic mergers, acquisitions and joint ventures. All of these combinations will require funding, with the best source being the New York capital markets. Privatizations are newsworthy and present opportunities for useful publicity; however, compared to the larger and more subtle phenomenon of free trade or treaty driven effects, they are of lesser economic importance.

## **Industrialization**

The emerging new economic order comprised of decentralized, pluralistic market economies effected by privatization and free trade agreements, provides the foundation for industrialization. Lenders and investors are cautiously funding new industrial projects in Latin America after an hiatus of roughly a decade. In Eastern Europe this process is developing for the first time since before World War II. This economic consequence results from the effect of the emergence of market economies on the confidence of lenders and investors. The industrial opportunities arising in this scenario are the newest and have attracted the least attention to date (at least in Latin America). Reducing these opportunities to value also requires significant innovation. Hence, in many ways they are the most interesting. Given the need of significant Latin America companies to restructure and reindustrialize, the demand for these transactions is strong. In Eastern Europe, the respective economies need to be completely reindustrialized, so the demand is very high. Extraordinary opportunities exist for those who can satisfy this demand.

### **THREE APPLICABLE FINANCING TECHNIQUES**

Three separate financial opportunities can be distilled from developments in the basic business environment, viz., privatizations, free trade or treaty driven transactions and industrial projects. A generic grasp of these three, separate

opportunities can be developed by considering the current, common transactional structure used to finance the three. Techniques for financing these three opportunities may diverge structurally over time and the relative importance of each may change, but for the present there is a common theme for all of them.

### **Export Driven Receivables Financings**

Theoretically, privatizations and treaty driven transactions and project financings involve two specific and different transactional forms. These two forms are financings based on corporate assets and financings based on projects. If a privatization or treaty-driven transaction depended on the security of corporate assets, especially purely domestic assets, it could not be done in this market. If a financing were structured purely on a project basis, the market also would not support these financings at this time. These transactions do become feasible, however, as a result of the exports (broadly construed) which are commonly involved. Assuming an acceptable production and delivery record, exports generate cash flows which dramatically change the risk of the financing if the export profile is appropriate and the financing is properly structured. Properly developed, these financings allow lenders to escape domestic asset, project and other risks and move into a more acceptable risk profile.

Whether a privatization, a treaty-driven transaction or a project financing is involved, the primary funding vehicle to date has been the receivables financing grounded in exports.

Structurally and conceptually speaking, these financings are very simple. The form is also very old. In fact, it is one of the oldest forms in existence. The only new elements are the use of hedging where necessary, the projection of the facility from the domestic to the international arena and the great increase in size.

Obviously, the characterization of this funding vehicle as a receivables financing greatly simplifies the matter. The documentation involved is extremely intense and is designed transaction by transaction for the specific situation at hand. Each transaction has to survive a rigorous and sophisticated filter. Detailed attention is given the characteristics of the source of the receivable, the source of the cash flow, the activities of borrower and the surrounding economic environment. Transaction costs are similar to those involved in comparably sized LBO's. These are not transactions for the newly initiated or the faint at heart.

Despite the rigor of the documentation, if you want to privatize a steel company, for example, if you have established exports in a financial and corporate configuration that can survive the applicable filter, you could finance the acquisition of this company from the relevant government. The same form used to finance a privatization can just as readily be used to finance a strategic acquisition driven by considerations relating to the impending free trade agreements. Suppose you were a producer of forest products and wanted to buy capacity and market share to

protect against increased competition from U.S. producers. To the extent you had exports in a situation that could survive the filter applied to these transactions, you could finance the acquisition of this additional capacity and market share. Similarly, if you were the owner of an industrial facility and wanted to expand capacity, if you have exports and survive the filter, you could finance this project using this form of financing.

#### **Light Industrial Developments Using Small Receivables Financings**

One particular form of project that can be easily financed using the vehicle described bears special mention. This form involves very small projects ranging in size from about two million dollars to six million dollars. Large financial institutions would not be interested in these unless they could be done in volume. They are, however, compelling. The concept largely originated in Mexico where it has directly and indirectly created nearly one million jobs. It would work equally well in Eastern Europe.

The concept is that of the Maquiladora Industry. Small, light industrial facilities are built where national borders and prevailing economic conditions create significant cross-border labor cost differentials. In very simple terms, industrial processes are organized into labor intensive and capital intensive operations and the labor intensive operations are transplanted to environments where labor costs are lower. Good jobs are created and productivity is enhanced. Because the

projects are individually small and diverse, there are valuable portfolio effects. More importantly, inherent in most projects are significant technology transfers, commercial training, management training and infrastructural improvements.

A Maquiladora Industry for Eastern Europe is not an end in itself. The objective should be full industrialization. The best place to begin any serious undertaking, however, is at the beginning. The distribution of hundreds of small, light industrial facilities throughout Eastern Europe could provide the foundation for necessary capital formation, both economic and human, and the springboard to full technological and industrial equality and well-being.

As time goes on, confidence in the emerging economies will grow. At the same time, the easier, more prominent transactions will be completed using the vehicle described above. Concurrently, there is and will be a grave need for major infrastructural improvements. All of the emerging economies need highways, power plants, telephone systems, railways, waterways, port facilities, airports and other, similar projects. Most of the more difficult and almost all of the infrastructural projects do not survive the filter used to select the financings underway at present. The basic difficulty is the more domestic character of these projects. These undertakings might be partially financed using the structure described above, but some new concepts will have to be introduced.

### **Dollarized Receivables**

The domestic character of the transactions presents several problems, but the most difficult concerns exchange risk. The transactions are amenable to the receivables structure, but the domestic transactions giving rise to the receivables and the cash flow are in the local currencies. The financings being in hard currencies, exchange risk is created. In the absence of forward or futures markets, this risk cannot be hedged. Assuming forward or futures markets do not develop, there are two possible solutions to this problem, both awaiting future developments. The first of these solutions turns on the possible dollarization of the economy in question. To the extent the economy is dollarized, the transaction being financed generates dollars, and capital transfers are essentially unrestricted, exchange risk declines and the transaction becomes more feasible.

### **Regulated Exchange Flow Receivables**

The second solution is somewhat more futuristic and depends on the regulatory or administrative law structure of the economy in question. In the U.S., we have a regulatory or administrative law system which is relatively predictable and functions in many instances to set rates for certain services. For example, there are rate making proceedings for utility companies, interstate telephone transmissions, railroad freight shipment and other, similar, basically infrastructural functions. These proceedings are designed to regulate the real returns to

the power, communications, transportation and similar producers. To the extent capital transfers are essentially unrestricted and the system functions to preserve real returns, this procedure can be used within the economy in question to maintain a predictable dollar equivalent flow of the local currency and exchange risk can be controlled by virtue of this "regulated exchange flow".

#### **FUTURE POSSIBILITIES**

Both of these concepts, dollarization and regulated exchange flow, remain to be implemented in the future, if at all. To some extent, they are merely exemplary of the possibilities. These possibilities are created by the transformation of the world economies into pluralistic, market based organisms operating in a relatively stable and peaceful environment. The premise for all of these transactions and the financing techniques now in use is that the world economic scene is more soundly based than before. In this context, financiers and their clients and lawyers can invent a wide variety of new solutions to old problems, can apply old solutions to new problems and can even venture new solutions to new problems. All of this they can do with greater confidence than before and successful execution will generate financial rewards of extraordinary proportions.

#### **ETHICAL CONSIDERATIONS**

In closing, I would like to briefly mention an ethical component of the opportunities I have described that is just as important as the economic component. This ethical component involves the inherent value of participation in the changes now

underway in the centralized economies. The economic stagnation caused by centralization has caused real hardship to real people. A focus on the trend toward decentralization presents the opportunity for profit, but perhaps more importantly, it affords the opportunity to do work that is really worth doing. There are substantial reasons to believe that efforts in aid of decentralization will bring good jobs to people who really need them and will uplift people who deserve opportunity. Apart from the commercial attractions, the situation affords a chance to act in support of a very positive movement and to bring lasting credit to all who play a role in these efforts. This mission should be undertaken not only in the interest of profit, but also with the spirit of public service which is one of the great ideals of our society.