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AGENCY FOR INTERNATIONAL DEVELOPMENT

EVALUATION PAPER 1A

THE USE OF PROGRAM LOANS TO INFLUENCE POLICY

PART 1: SUMMARY AND CONCLUSIONS
and
PART 2: COUNTRY STUDIES

PPC/EVALUATION STAFF
MARCH 1970

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MEMORANDUM FOR THE FILES August 24, 1977

FROM: PPC/PDA/SPA, John R. Eriksson

SUBJECT: Declassification of Evaluation Paper 1A

1. I have reviewed Evaluation Paper 1A, "The Use of Program Loans to Influence Policy", CONFIDENTIAL, March 1970. I have also discussed the report with two of the original authors, Ted Rice and D.H. McClelland, and with Jim Brown of PPC/PDA (who has also reviewed it at my request).

2. I have decided, on the basis of these reviews and discussions, to declassify the report.

cc: AA/PPC, FSeki
PPC/EMS, MJacobsen
AG/SEC, MMileski
DM/IM/RS, EFalbo

JB:ltw

PN AAQ 813

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THE USE OF PROGRAM LOANS TO INFLUENCE POLICY

PART 1.: SUMMARY AND CONCLUSIONS

by

Donald R. Snodgrass

with the assistance of

Edward B. Rice

Appendix: A Summary of Reviewers' Views

by

Donald H. McClelland

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THE USE OF PROGRAM LOANS TO INFLUENCE POLICY

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*Consolidated numbers for PART II are at bottom of pages

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THE USE OF PROGRAM LOANS TO INFLUENCE POLICY

PART I - SUMMARY AND CONCLUSIONS

A.I.D. EVALUATION PAPER 1A

THE USE OF PROGRAM LOANS TO INFLUENCE POLICY

PART 1. SUMMARY AND CONCLUSIONS

by

Donald R. Snodgrass
with the assistance of
Edward B. Rice

PART 2. COUNTRY STUDIES

by

Donald R. Snodgrass
Edward B. Rice
Carl J. Hemmer
Elizabeth Carter
with the assistance of
Allen Goldstein

March 1970

(Research was largely completed by January 1969. Thus tho argument does not reflect changes in program lending policies in FY 1970 or the end of FY 1969.)

A.I.D. Evaluation Papers represent the views of their authors and are not intended as statements of Agency policy.

I. INTRODUCTION

This paper reports on a study carried out by PPC's Evaluation Staff covering the period Fiscal Year 1962 through Fiscal Year 1968. The initial aims of the study were to determine whether program loans provide "leverage" on self-help performance, and also whether a number of factors sometimes hypothesized to influence leverage in fact do so. Among the latter, the formal conditioning system, with its quantified targets and staggered tranche releases preceded by performance reviews, was prominent in our thinking. We were intrigued by a discrepancy between the written and oral records on these issues. On the one hand, Program Loan Papers, LAS's, CAP's and PM's describe the program loan as A.I.D.'s major vehicle for influencing the host government's economic policies. On the other hand, many A.I.D. officers who had been involved in loan negotiations and tranche reviews seemed to question the value of aid conditioning, especially formal conditioning mechanisms. They argued that the host country does little that it would not have done otherwise and that formal conditioning puts an unjustified strain on work loads, tempers, and bilateral relations in the field. Our aim was to step back from the rhetoric and heat of the loan negotiations and see whether the seven-year documented record of eight major program loan countries in Asia, Africa, and Latin America yields any general conclusions regarding "leverage" and its relation to conditioning and other hypothesized influences.

The study was carried out in two phases. In Phase I, PPC/POL/ES reviewed in considerable depth the history of A.I.D. Development Loan non-project assistance to India, Pakistan, Turkey, Tunisia, Brazil, Colombia, Chile and Korea. These countries have all been receiving U. S. program loans since FY 1962 or FY 1963 (except for Korea, which got its first program loan in FY 1966). Phase I research was limited primarily to documentary evidence, in particular the regional loan files and budget submissions. Draft country and general papers were prepared on the basis of this work. Any gaps or misconceptions present at the end of Phase I have been corrected, we hope, in Phase II. In this part of the study, we interviewed principal A.I.D. participants in all eight of the country experiences studied, often using our draft country papers as a starting point. Besides sharpening and filling out the narratives derived from the documentary record, the interviews helped to breath life into our understanding of the country experiences and clarify our perception of which of the many issues surrounding program lending are decisive and which less important.

Our conception of what the study was about changed somewhat as we went along. We originally intended to define the limits of the study rather narrowly We decided to limit ourselves to the leverage effects of the program loan and ignore the other rationale for program lending -- the recipient country's need for a resource transfer to fill a balance of payments and/or investment gap, encourage private enterprise, or increase the utilization of existing productive capacity. We also decided to concentrate on the leverage effects of the program loan and look only incidentally at the leverage effects of other aid instruments In practice, we found these two boundary lines difficult to maintain. We discovered that leverage, at least in the narrow sense defined in the succeeding section, is only part of a significant broader concept, which we will call influence. And we learned that various types of influence and various aid instruments are often so closely interrelated that one often cannot study one without examining others at the same time.

As restated, then, the questions we tried to answer are whether the program loan (perhaps supported by other instruments) has been used to influence policy, what factors either internal to the influence process or external to it affect the degree of influence obtained, and how the program loan compares to other aid instruments as a vehicle for influence. The last of these questions can only be answered relative to a general idea of what other forms of aid can do, since we have not studied project or sector lending in anything like the detail devoted to program lending.

By concentrating on the program loan we do not mean to imply that it is the only way to exert influence. A.I.D. and its predecessor agencies have always wielded some influence on host government policies, by a variety of means. For instance, the immediate precursor of the program loan -- the SA grant -- was sometimes used as an instrument of leverage and still is in Korea, Bolivia, the Dominican Republic, and the Congo(K). Nor is it possible completely to disentangle the influence of the program loan in particular from that of the aid package in general. We decided to study the program loan because we thought that it has become the main focus of attempts to obtain influence. Our conclusions, we believe, bear this out.

One important aspect of our subject which we have chosen to ignore is the correctness and quality of the policies A.I.D. has urged upon program loan recipients. A judgment on this question would clearly be worth having, and could be crucial to one's overall view of the influence process. However, any formal evaluation of this aspect would have to cover the whole range of development economics. We have, therefore, chosen to concentrate on whether the Agency's attempts to influence policy have been successful with only an implicit assumption that they have generally been well conceived. In other words, we have done an effectiveness rather than a significance evaluation.

As all evaluation studies should, we hope this one will influence Agency policy. We have, therefore, tried to formulate and substantiate conclusions which can be taken into account in future choices between program loans on the one hand and both project and sector loans on the other, in decisions about the kind of conditioning system to use, and in other operational questions.

The study was conducted as a part-time activity during the year beginning March 1968. It was directed largely by Donald Snodgrass, Chief of the PPC Evaluation Staff. Others who worked on the project were Edward B. Rice, Allen Goldstein, Elizabeth Carter and Carl J. Hemmer. (The final stages of the study were carried out under the general direction of Donald H. McClelland, who succeeded Mr. Snodgrass as Chief of the Evaluation Staff in November 1968.) During Phase II of the work, interviews were conducted with approximately 40 AID officials. Useful comments were also received from other officials, as well as from members of the Administrator's Advisory Committee on Economic Development. The generous cooperation of all these people has greatly improved the quality of this paper, and the authors are high appreciative.

II. DEFINITIONS

"Leverage" is a commonly used term but a slippery one. It can be precisely defined as the process of bringing about host government actions which would not otherwise have been taken, using foreign aid as an indirect quid pro quo but not as a direct means of financing the desired action.

"Influence," as we will use the term, is a broader concept. It embraces both leverage and persuasion. A.I.D. often simply persuades a host government to do something it would not otherwise have done, without conditioning any specific amount of aid upon it. The potential for persuasion depends on A.I.D.'s possession of superior knowledge about the benefits or costs of particular actions, plus the ability to convince the LDC government of its superiority.

There is, of course, one other way for A.I.D. to get things done -- by reducing or eliminating the cost of the desired action to the host country by directly financing it, entirely or in part. We confine the ideas of both leverage and influence to actions not directly financed by A.I.D. The building of a power plant is not an example of leverage if A.I.D. pays the costs of construction, but the introduction of power rate reforms as a condition of the loan is.

In a very narrow sense, program loans do not directly finance any specific activity. In this sense, any activity they generate represents influence. In a very broad sense, any action a host government agrees to take as part of a progr... loan agreement is "financed" by the loan, since the agreement is voluntary and the host government would not enter into it if it did not judge the benefit of the loan to outweigh the costs of the actions it has agreed to undertake.

Within these wide limits, some program loan conditions are more directly financed by the loan than others. Import liberalization is the most important example of a loan condition for which the linkage is relatively direct. The host government may well favor import liberalization per se but be unwilling to pay the cost (in the form of other actions necessary to achieve it) within fixed resource availabilities. But if aid is increased, the internal cost of liberalization is reduced and the action becomes easier to take. This kind of loan condition is a less clear-cut example of leverage than the kind in which A.I.D. does not reduce the painfulness of the action requested, but compensates by allowing the host government to get something it values in some other sphere. Thus, if a program loan "buys" an income tax reform, the reform itself does not become easier to effect, but the host government becomes more willing to tackle it because it received other benefits (e.g. reduced need to restrict imports). In all cases, however, leverage is a two-way process in which each side gives something to get something in return.

Program loan negotiations generally involve both persuasion and leverage. The relation between the two is complex and debatable. Some say (though, as noted below, we do not agree) that leverage in the sense defined above does not exist, that aid recipients will not perform loan conditions unless they are persuaded that the policies advocated are desirable in themselves. In any case, having defined the key concepts involved in our study in precise terms, we must admit that it is frequently impossible to distinguish them from each other in practice. Accordingly, we will use our terms more loosely in the rest of the study than in this section, allowing leverage and influence to be near synonyms.

III. A.I.D.'s PROGRAM LOAN EXPERIENCE

A. General

We date program lending from FY 1962, although three countries (India, Israel, and Argentina) received dollar loans for commodity imports in FY's 1958-1961. Use of the program loan was greatly expanded in FY 1962, responding to the basic policy decision taken at the time of A.I.D.'s creation to shift from grants to loans. In Pakistan, Turkey, and Tunisia, the new lending instrument replaced DS/SA grants (DS before FY 1961 and SA in FY 1961). India, as just mentioned, had already shifted to loans. Brazil, Chile, and Colombia had not participated in the commodity grant program; for them, program support was entirely new and resulted from the recently christened Alliance for Progress. Our eighth country, Korea, did not begin the transition to loans until FY 1966.

The feature of the program loan which distinguished it from the commodity grant -- aside from the unpopular repayment factor -- was the idea that it would only be provided to countries which could formulate a program of development and offer a significant "self-help" contribution to it. To ensure compliance with these criteria, conditioning systems with varying degrees of rigor were developed by the Regional Bureaus. As the Agency's interest in self-help has increased, these conditioning systems have been strengthened.

The eight countries we have studied are the only ones in which DL program lending has been sustained for a number of years and still continues. Korea is included because, although program loans are a recent addition to the country program, the country has been the scene of innovations in conditioning. Annual figures for program lending to these eight countries are shown in Table I. Summarized descriptions of the lending and conditioning experiences follow. In addition to the eight countries we have examined, program loans have also been extended to Argentina (FY 1962), Taiwan (FY 1962 and 1963), Ghana (FY 1967), Tanzania (FY 1964), Afghanistan (FY 1966), Ceylon (FY 1967), Greece (FY 1963) and Costa Rica (FY 1968). Moreover, SA and PL 480 programs in still other countries have been invested with a self-help conditioning system comparable to one of the program loan models. We have not studied these other experiences, however, because we believe that the most important lessons are to be learned from the eight countries in which program lending has been sustained and systematic.

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TABLE I

PROGRAM LOANS - MAJOR COUNTRIES
gross loan obligations 1/, millions of dollars

	BRAZIL	CHILE	COLOMBIA	INDIA	PAKISTAN	TURKEY	TUNISIA	KOREA	(SA) 7/
FY 62	74.5 2/	(100.0) 3/	(30.0) 3/	200.0	132.0	-	10.0	-	(89.8)
FY 63	(25.5) 3/	35.0	60.0	240.0	100.5	35.0	15.0	-	(89.0)
FY 64	(50.0) 3/	55.0	60.0 6/	275.0	100.0	70.0	10.0	-	(75.1)
FY 65	150.0	80.0	-	190.0	140.0	80.0	10.0	-	(69.7)
FY 66	150.0	80.0	65.0	300.0 5/	120.0	70.0	15.0	10.0	(60.5)
FY 67	100.0 4/	- 2/	100.0	182.0	70.0	65.0	15.0	15.0 8/	(44.1)
FY 68	75.0 12/	15.0 12/	58.0 12/	248.0 5/	140.0 5/	40.0	10.0	10.0	(30.0)

relative lending levels

	BRAZIL	CHILE	COLOMBIA	INDIA	PAKISTAN	TURKEY	TUNISIA	KOREA
av. level 9/	125.0	80.0	60.0	235.0	113.0	70.0	13.0	13.0
$ per cap. 10/ (population)	1.5 (84.0)	9.1 (8.8)	3.2 (18.7)	0.4 (501.0)	0.9 (117.0)	2.2 (31.9)	2.9 (4.5)	0.4 (29.1)
% of imports (imports) 11/	9.7 (1290)	12.3 (650)	10.5 (570)	8.0 (2830)	11.2 (980)	11.5 (610)	5.2 (250)	2.5 (530)

Footnotes

1/ Some figures differ from those in the individual country papers. The latter usually show net obligations, and they occasionally include loans in a subsequent fiscal year.

2/ $100 million was committed in FY 61 for future obligations. Only $74.5 million of DL was ever obligated.

3/ Contingency loans. The Chile $100 million FY 62 loan was for earthquake reconstruction.

4/ $100 million was obligated in FY 67; however $75 million was withheld pending agreement on a new stabilization program in early CY 1968. Of that $75 million, $50 million was tied to new FY 68 obligations of $75 million as part of the FY 68 program loan package.

5/ Includes fertilizer loans (India, Pakistan).

6/ Of which $10 million was deobligated for nonperformance.

7/ Net commitments of SA grants. See narrative.

8/ Of which $2.5 million was deobligated for nonperformance.

9/ Hypothetical average annual program lending level, assuming harmonious negotiations ($ millions).

10/ 1966 midyear population (millions).

11/ Average annual commodity imports 1964-1966 ($ million).

12/ Excludes sector loans (Brazil, Chile, Colombia).

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B. BRAZIL

Capital assistance to Brazil started with a program loan of $75 million to President Goulart's Government in FY 62. Negotiations broke down the following year and were not resumed till Castello-Branco replaced Goulart in April 1964, though smaller, contingency loans and about $75 million of project loans were authorized in both FY 63 and FY 64.

Three program loan agreements were signed with Castello-Branco's Administration: $150 million in each of FY 65 and FY 66 and $100 million in FY 67. Disbursements of the last loan, which took place under a successor Administration (President Costa e Silva), have been considerably delayed. An FY 68 loan of $125 million was signed in June 1968, but this included $50 of undisbursed FY 67 funds. Project lending has continued at an annual level between $70 and $100 million. A PL 480 program began in FY 61 but it has been fitful, with no deliveries in FY 65 and FY 67. IMF has maintained a presence in Brazil since 1961, and after the 1964 revolution helped establish a comprehensive stabilization program. But IMF-GOB relations have not been continuous, and the U. S. sometimes had to prop them up. There is no donor consortium.

A.I.D. developed an elaborate conditioning system in Brazil. The first A.I.D. quantitative policy performance targets established anywhere as conditions of loan disbursements were written into the abortive Bell-Dantas Agreement of FY 63. When the "modern" era of LA program lending began in early FY 65, a quarterly tranche release schedule with preceding performance reviews was instituted and this system has continued -- not entirely smoothly -- ever since. Explicit conditions were written into an annual letter from GOB to the CIAP and extensively quoted in the bilateral loan agreement. These conditions involved a variety of monetary, fiscal and other stabilization indicators and an increasing number of development policy targets (though sectoral targets in education, health and agriculture are now being transferred to sector loans).

Performance has varied and so have disbursements. Since 1964 the GOB gradually brought inflation under control by improved management of public expenditures and bank credit. But there have been relapses, with credit exceeding quantitative targets and pressure building on exchange reserves. A.I.D. has maintained a credible posture by delaying tranche releases in FY 66 and terminating them in FY 67. This position appears to have paid off in desirable policy and institutional changes that would not have occurred as early otherwise, particularly when Roberto Campos was in a position (as Minister for Planning and Economic Coordination under Castello-Branco) to use the A.I.D. conditions for leverage on his own government. In addition to aggregate fiscal and monetary policies, one can point to import liberalization and to changes in the operation of state economic enterprises, in domestic coffee policy, and in incentives to farmers as areas where U. S. leverage probably worked. "Success" fell considerably short of announced expectations, but the latter were often set at the optimistic end of the feasible range as an incentive for action.

C. CHILE

Program assistance began in FY 1963, a year after the first major U. S. loans to Chile. These consisted of emergency earthquake reconstruction aid and the immediate predecessor of program aid - a $40 million project loan to the Chilean development bank. Two program loan agreements were signed with the Alessandri administration: $35 million in FY 1963, and $55 million in FY 1964. Four have been signed with the succeeding Frei government: $80 million in both FY 1965 and FY 1966: $15 million in FY 1968 and $20 million (to date) in FY 1969. The GOC voluntarily declined program assistance in FY 1967 when copper prices rose sharply. AID also negotiated educational sector loans in FY 1967 and FY 1969, and an agricultural sector loan in FY 1968; Chile was the first country to experiment with sector assistance as a complement to program aid. Project lending started in the late 1950's, but shrank to very low levels by FY 1969. PL 480 authorizations have averaged $18 million per annum since FY 1962. Thus program lending has dominated the bilateral negotiations since FY 1962.

There is no donor consortium for Chile, but U. S. aid was dwarfed by IBRD/IDB loans in FY 1967 and 1968. There has been an IMF standby agreement in each program loan year, and performance requirements for standby eligibility have also been conditions for tranche releases.

Explicit loan conditioning began with the FY 1963 loan. Quarterly review sessions were introduced the following year. Frei's inauguration in late 1964 initiated the "standard" LA conditioning system -- which called for a host government letter to CIAP announcing economic policy and a schedule for performance in the budget year, a schedule to which AID program loan disbursements were tied. The letter covered development plans as well as stabilization policy and, consequently, the program loan conditions spanned the same broad spectrum. Only a handful of conditions were regarded as essential; these included the growth of the money supply, the level of the public sector budget surplus on current operations, and the rate of exchange depreciation. During FY 1966 the Mission also took a firm position with respect to agricultural support prices (which it wanted announced earlier in the season and at higher levels), the GOC use of copper windfall revenues, and policy on public sector wage readjustments. The FY 1968 and 1969 loans retained the form of earlier conditioning but, due to circumstances that greatly reduced the prospects for self-help gains, the performance standards were substantially relaxed.

The GOC performance has been uneven since 1962. In varying degrees, Chile met most of the quantitative budget and monetary conditions of the loans. The rate of inflation dropped sharply through 1966, but had nearly doubled again by the end of 1968. Overall, the GOC managed exchange rate devaluation with reasonable efficiency. A few of the institutional changes included as loan conditions were carried off according to the original timetable; most fell behind schedule. Frei has had trouble executing his party's announced plans for agrarian reform, in part because of opposition from the Chilean Senate. Public and private investment has expanded, and the popular participation programs in rural and urban areas appear successful. In 1968, the Frei regime began to experience the political limitations of a lame-duck administration, an obstacle to needed self-help reforms that was greatly compounded by the beginning of a disastrous drought that is reducing tax revenues and expanding public expenditures. Despite the recent setbacks, the record shows markedly better performance under Frei than under Alessandri, particularly in view of the larger range of reform measures undertaken by Frei during 1965 and 1966.

All loans were fully disbursed. There were delays in the release of many tranches, but only two of these were clearly associated with non-fulfillment of performance conditions (i.e. in mid-1965 and mid-1966). The usual reason for delays was the late submission of material by the GOC for the review.

D. COLOMBIA

A.I.D. has made seven program loans to Colombia, involving gross obligations of $373 million. The first was a rather haphazard balance of payment loan extended on short notice in FY 1962. After that inauspicious beginning, A.I.D. made a series of increasingly serious attempts to use program loan money to influence GOC policy. An FY 1963 loan tried to support a recent IMF recommended devaluation, using tranche releases and reasonably explicit performance conditions, but it failed. The Mission's reaction was to make conditions more numerous and specific in its FY 1964 loans. However, this attempt also failed, as Colombia entered a foreign exchange crisis and GOC relations with the aid agencies broke down amid a dispute over devaluation and other policy reforms. Part of the second FY 1964 loan was withheld and eventually deobligated.

Not until the Fall of 1965 did the GOC take the steps necessary to bring the aid agencies back. When it did, A.I.D. concluded an elaborately conditioned FY 1966 $65 million loan, involving 73 separate conditions and quarterly performance reviews. The reviews went off fairly well and all funds were released, but in December 1966 another exchange crisis flared up. Again, GOC-IMF relations were strained beyond the breaking point over the devaluation question. The GOC imposed trade and exchange controls, reversing much of the liberalization the U. S. had been seeking. Relations resumed in early 1967, however, and a 15-month agreement, similar in structure to the FY 1966 one, was signed. Again the reviews were generally favorable, but again there was a diplomatic crisis at the end of the program loan year (early 1968). This latest dispute, over additionality and import liberalization, has since been patched up and FY 1968 program and agriculture sector loans have been signed. They generally repeat the conditioning pattern of FY's 1966 and 1967, though they are noticeably looser in terms of number and specificity of conditions but, we are told, sharper and more realistic in focus. In the last year, the IBRD's Colombia Consultative Group has begun to play an important role in the policy arena.

Colombian experience appears to have substantial relevance for our study. It is a case in which (since FY 1963) we indisputably tried to exert leverage with the program loan. Colombian performance was mixed. The FY 1963 and 1964 loans are clearcut failures from the leverage point of view, but the FY 1966 and 1967 loans were successful in the sense that most of their policy conditions were satisfied. However, in both years generally favorable review findings were quickly succeeded by crises and backsliding. Over the 1962-67 period as a whole it is possible to point to many important measures which were taken after A.I.D. and its IMF and IBRD allies experssed a strong interest. On the other hand, Colombian performance with respect to most of the variables the aid agencies were trying to influence was lackluster. There were signs of improvement late in the period, but still no decisive shift to a more dynamic pattern of growth. Colombia provides an example of fruitful multilateralism. It also demonstrates both the strengths and weaknesses of a strict, multi-condition system. It gives some credence to the notion that the political costs of exerting leverage cumulate through time, making it increasingly difficult to get leverage in successive negotiations. However, one can argue that this pressure can work against the formal trappings of the "LA system" without necessarily undermining aid conditioning imposed and enforced by less formal means. Time will tell.

Many of the disappointments encountered in attempting to influence Colombian development are probably attributable to the severity of Colombia's structural economic problems and the shortcomings for development of its unique political system.

E. INDIA

Non-project lending to India began in FY 1958. The level was increased substantially in FY 1962 with the start of A.I.D.'s program loan period. A.I.D. program assistance to India averaged about $225 million from 1961-1962 to 1964-1965 in terms of commitments to Indian fiscal years (IFY's are April to March.) There was a low year of $50 million in IFY 1965-1966 following the India-Pakistan war in the Fall of 1965. Commitments rose to $382 million in 1966-1967 and $275 million in 1967-1968. DL project lending declined after 1962, when A.I.D. decided to give higher priority to non-project assistance. Since the India-Pakistan war and the commencement of India's economic reform program in 1966, program loans have completely dominated the category of dollar aid, comprising about 85% of A.I.D. assistance in FYs 1967 and 1968. Program loans have run at a level lower than PL-480, Title I. The latter (country uses) averaged over $230 million between 1961 and 1964 and peaked at $548 million in 1966.

Before 1964-1965, leverage, both bilateral and multilateral, was quite low key. The IBRD and the U. S. discussed desirable Indian self-help actions informally with the GOI, but Indian performance and development policies were generally considered acceptable. U. S. program loans during this time had no conditions attached. After the India-Pakistan war, conditioning became more explicit and some quantitative targets were negotiated though usually not linked specifically to program loan agreements. U. S. bargaining probably was more effective, both because India was suffering from a drought and because the routine of a constant level of A.I.D. commitments had been broken. Also, It had become more obvious to the GOI that its economic policies needed a significant change.

Since the war, the principle role for conditioning of non-project assistance from the U. S. and other Consortium members has been assumed by the IBRD, acting both as Consortium chairman and a major donor. In the Spring of 1966, IBRD negotiations with the Indians were quite rigorous and specific achievement targets were set. There was particular emphasis at this time on import liberalization and agriculture. Other policies such as export promotion, decontrol of industry, encouragement of private foreign investment, and family planning were also covered. Some target dates were stated for the coming year; others related to the end of the Five Year Plan (1971). After the discussions, and an Indian commitment to a new economic reform program, the Consortium pledged $900 million in non-project assistance for that IFY to enable the Indians to carry through the program. Over the next few years, the IBRD and the Consortium reviewed Indian performance on the policies agreed to in the Spring 1966 meetings. Pledges of annual Consortium non-project assistance were contingent on adequate Indian progress. The U. S. has pledged about 42% of this assistance each year; and as the largest single donor, the U. S. has had an important role in determining multilateral leverage policy.

Though the U. S. has let the IBRD perform the major leverage role in India since 1966, U. S. bilateral leverage has been significant too. The approach has been predominantly one of a "continuing dialogue" with GOI officials, not specifically related to program loan agreements, except for fertilizer matching requirements. Loans for a given Indian fiscal year have been made in more than one agreement, but releases have not been cycled to formal reviews and specific target achievements. However, since program loans constitute the bulk of U. S. dollar assistance, they have implicitly been the basis for U. S. leverage on Indian policies, primarily on fertilizer policy, general agricultural policy, decontrol and more recently on export promotion. GOI self-help actions have often been taken before a loan is signed. For instance, a loan was signed in 1966 after the GOI had devalued the rupee. Further loan agreements have been held up to induce the GOI to take action.

An important source of U. S. leverage on Indian agricultural policies has been the negotiations preceding PL-480, Title I agreements, beginning in the latter half of 1965. After a four-year PL-480 commitment expired in July 1965, the U. S. signed only short-term agreements for a one to three month supply of food grains until a six month agreement was negotiated in late 1967. These short-leash agreements were designed to maintain a continuing watch on Indian agricultural policies and increasingly on family planning as well. U. S. leverage here was more closely linked to the signing of aid agreements than that relating to the program loan.

Many of the policies which established a new priority for agriculture in India's Fourth Five-Year Plan (1966-1971) were agreed on initially between the U. S. and Indian chiefs of agriculture in November 1965. They were subsequently accepted by the GOI and presented to the Indian parliament. Probably most of the policies were those previously advocated by the Indian Minister of Food and Agriculture but he had lacked the support of the Indian cabinet. The following and subsequent PL-480 agreements listed unilateral Indian actions taken or planned. Evidence of U. S. imposed conditions was not apparent, but before each agreement was signed a hard look was taken at the progress of the agriculture programs and sometimes quantitative targets were negotiated and spelled out in side agreements or minutes. Some agreements were held up pending further GOI commitment to action. PL-480 agreements were thus used in concert with program loans to influence Indian self-help performance, particularly concerning agriculture.

Between 1962 and 1966, GOI self-help performance rates fairly low. This is also the time of fairly low U. S. and Consortium pressure on the GOI. Since the 1965 war, however, when the A.I.D. and Consortium positions stiffened, there has been noticeable improvement in self-help performance, though less than the donors had hoped. India did not receive as much assistance as anticipated to liberalize imports during this time. Further, there were two severe droughts, a resultant depression, and political difficulties within a government that is both federal and actively democratic. There has been substantial progress in some areas stressed by the U. S. and the Consortium. Great strides have been made in agricultural production, foreign private investment has been encouraged particularly in the fertilizer industry, controls of the domestic economy have eased considerably and a family planning program is underway. Some liberalization of imports did take place and has been maintained despite decreasing aid flows. Indian performance is partially due to factors other than the leverage process, but U. S. and Consortium leverage clearly played an important part.

F. PAKISTAN

Program lending began in FY 62, with two loans totalling $132 million. Program lending replaced an old SA grant program that averaged $90 million annually from FY 59 to FY 61. Project lending was almost as large as program lending through FY 64, but has fallen to $30 million per annum since. PL 480 imports -- measured by U. S. prices -- have usually outranked the program loan; thus, although the program loan has recently dominated the U.S. dollar aid program, it has not dominated the U. S. aid package as a whole. At least one program loan has been made in each FY since 1962, the average annual authorization being about $110 million. When two loans were authorized in the same year (FY 62, 63, 66 and 68), the second was independently negotiated and never handled as a tranche. That is, the release of the second loan was not conditioned upon performance goals established by the first. One partial exception to this pattern was when war disrupted AID-GOP relations for four months and, for a time, slowed the rate of annual program lending.

The bilateral conditioning system has been relatively informal, though not so informal as in India. Bargaining was confined to the original negotiations carried on within the framework of a "continuing dialogue." The Mission never used the loan release mechanism for leverage: once the Agreement was signed, release was automatic. Only a few conditions were introduced into Loan Agreements, most of them since the India-Pakistan war. The primary condition -- which has been a continuing area of negotiated change since the inception of the program loan -- is import liberalization. There have also been clauses requiring improvement in fertilizer policy and -- beginning in 1966 -- reduction of the military budget and a shift of funds to the development budget. The conditions were generally stated in qualitative form, that is, without quantitative targets or a schedule for progress.

The program loan as an explicit instrument of leverage was used more narrowly in Pakistan than in most countries. The principal forum for self-help discussions was not the bilateral negotiations but the annual IBRD Pakistan Consortium sessions, in which the U. S. representatives and U. S. resources played a major role. There, in addition to import liberalization, joint positions on fiscal policy, population control, agricultural development and industrial decontrol were hammered out and revealed to the GOP representatives. Apparently the Consortium position was not structured by quantitative targets and deadlines, or threats on the aid level, though the difference between this process and an overt leverage operation may only be one of degree, since any inadequate performance on the part of the GOP could easily have been penalized in the subsequent pledging session.

Aside from the war period, the overall Pakistan performance since 1962 has been good, considerably better than India's. The major economic indicators have exceeded expectations: the annual increase in real GNP averaging 6%. The GOP properly claims most of the credit for establishing the economic environment which produced the creditable record. In the areas stressed by the Consortium and reinforced by the A.I.D. bilateral negotiators -- liberalization, the military budget and agriculture -- the record is good. The most immediate test of program loan leverage ought to be GOP performance in import liberalization (and industrial decontrol) -- the policy area of highest U. S. priority. Here performance has been spotty. Considerable progress before the war was wiped out by renewed restrictions in the year following it (1966). This ground was regained, however, and there has been a move toward further relaxation in FY 1968. To a large extent, however, the variable behavior reflected the GOP's expectations of the availability of foreign exchange, an indication that both progress and retrogression were as much the result of A.I.D.'s willingness to finance import liberalization as it was of leverage. The GOP has significantly reduced the military budget proposed in early 1966, and is apparently achieving a major breakthrough in agricultural productivity.

G. TURKEY

Program lending to Turkey started in FY 1963, replacing at about the same $70 million level the ten-year old SA grant program. A program loan was made at approximately that rate each year through FY 1966, after which it fell to $40 million in FY 68, in part because of A.I.D.'s worldwide funding cuts. The loans have usually been disbursed in two tranches, conforming to the GOT's semi-annual import program. Mission documents describe the second tranche as an opportunity to reengage the GOT in discussion of broad policy, but in fact the reviews when made have been perfunctory and all tranches have been released on time. Project lending started in the 1950's. In FY's 1963-67 it was maintained at a level not much below the program loan. PL 480 imports have been heavy in the past, but tapered off to zero by FY 1967. The U. S. is a member of the Turkish Consortium, an OECD sponsored group including most donors. The Consortium has been an effective device for increasing the other-donor share in Turkey's aid commitments during the 1960's from 10% to 60%, but it has not been an effective forum for promoting self-help performance. On the other hand the IMF has had a harmonious relation with GOT since the officers' revolt of 1960, signing Stand-by Agreements each year. The Fund can take considerable credit for the prudent fiscal and monetary performance of the Turks.

The GOT rejected written conditions on U. S. program aid in 1963, and still regards them as an affront to sovereignty. However, the Turks have not objected to detailed discussions of policy issues during loan negotiations and A.I.D. has used those opportunities, plus the many others that present themselves during the "continuing dialogue" with the GOT, to press U. S. policy views. Sometimes an informal agreement on specific tests has been reached, with an unspoken understanding that non-performance could affect the size of the next annual loan offer (though not the second tranche of the negotiated loan). In the FY 1966 and FY 1967 discussions, the A.I.D. negotiators insisted on including among the conditions the IMF quantitative stabilization tests for those years. Recently, A.I.D.'s main thrust has been in improving and restructuring the balance of payments, in particular on increasing foreign exchange earnings and import liberalization.

Turkish economic performance has been well above average during the period studied. The general lines of GOT policy have also been acceptable to the U.S., with the increasingly important exception of the external trade and payments policy. Program aid has not been conditioned on Turkish performance, except in the general sense that the U. S. approved of the broad lines of Turkish policy. We have asked ourselves whether U. S. influence could have been greater and Turkish performance still better if more specific conditioning had been employed. We conclude that U. S. influence on GOT policy has been limited especially relative to the large volume of U.S. aid Turkey has received. We are also convinced that U. S. influence could have been greater if GOT had been made to believe that the volume of aid it received was more directly related to its self-help performance. We arrive at these conclusions even while accepting that overriding U.S. political/military interests in Turkey constrained the U. S. from establishing a completely credible "tough" posture on economic performance. Recent improvements in trade and payments policy, consequent upon A.I.D.'s toughened position in the FY 1968 negotiations, strengthen this conviction.

H. TUNISIA

Program loans were introduced in FY 62, replacing an SA grant series at about half its level. Program loans of either $10 or $15 million have been made every year since. A.I.D. released the FY 66 and FY 67 $15 million loans in two tranches, tying the second disbursement to mid-year performance. These two mid-year reviews were not exacting, however, and both second tranches were released on schedule. A.I.D. has frequently delayed agreement and disbursement, but the purpose has usually been to patch up the leakage of loan funds to France -- an apparently difficult exercise -- rather than penalize the GOT for nonperformance. Project lending has recently been running at half the level of program lending, and PL 480 deliveries have occasionally been very large, especially in FY 67. Nevertheless the program loan dominates bilateral negotiations.

A.I.D. played a role in getting the IMF and GOT together in 1964, when a loss of exchange reserves forced the latter to seek a Stand-by. The Stand-by has been extended each year since. A.I.D. also promoted the IBRD Consultative Group, and used the autumn CG meetings that began in 1965 to drum up some support for A.I.D.'s self-help performance program. However, except for allies on the IBRD staff and in the IMF (whose stabilization conditions the Mission once considered too weak) the U. S. has carried the burden of the self-help conditioning process. This has been awkward for the U. S., because every year since FY 62 it has insisted that it must soon phase out of nonproject assistance, and it couldn't easily threaten to cut the loan for nonperformance factors as well. But A.I.D. has tried without success to shift the burden onto the French and the EEC.

A.I.D. attached the first policy condition to program lending in 1964, when it obliged the GOT to draw the outline of a remedial balance of payments program and call in the IBRD staff to help. In FY 65 it got the GOT to initiate an Annual Economic Budget. In FY 66, a formal tranche system was installed, with quantitative and qualitative indicators identified in the Loan Agreement and observed in the mid-year review. The FY 66 conditions were limited to stabilization policy -- credit, public expenditures, taxes, state enterprises, etc. Agriculture and private investment targets were added in FY 67 and FY 68 against considerable GOT objection. The number of conditions has not been large, however, and the tranche reviews have been perfunctory.

GOT performance has been good. A few of the IMF and A.I.D. quantitative credit and expenditure ceilings were exceeded, but the excess appears not to have been excessive and has been excused. The GOT has worked with the IMF, IBRD, CG and A.I.D. to develop a more prudent fiscal policy, to the point of cutting back on President Bourguiba's popular social welfare programs. Moreover, private investment rates and general economic activity have done well. A.I.D.'s announced primary goals have been to restore the viability of Tunisia's foreign accounts, and find another principal donor. In this respect the conditioning exercise failed, but it probably should not be judged on these grounds since Tunisia was up against problems, aggravated by the loss of official French capital and naval base earnings, that were unsolvable in the short run.

I. KOREA

The first program loan (FY 1966 - $10 million) was signed in December 1965 and conditioned on performance in the third and fourth quarters of CY 1965. The second (FY 1967 - $15 million) was signed in July 1966 and conditioned on performance through the second and fourth quarters of CY 1966. The third (FY 1968 - $10 million) was signed in February 1968. It was initially conditioned on performance through the second and fourth quarters of CY 1967, then renegotiated to be based on mid-1968 performance as well. Each loan has had two tranche releases, based on fulfillment of up to five quantitative conditions, all relating to credit, fiscal, foreign exchange and other stabilization policies. Till 1968, each condition was worth a share of the loan, so that the penalty for non-performance was clear and depended on the number of conditions missed. A miss on one condition theoretically could be compensated for by good performance on another, though the possibility of such a trade off was not mentioned in the agreements and was probably not divulged to the ROGK. The targets and penalties were explicit and agreed in writing. The Koreans objected to the "schoolmasterish" approach of a point system in the first loan, so this system was subsequently put in a side letter. A.I.D. has used the penalty on several occasions. When the ROKG failed to meet one of three year-end targets for the second tranche of the second loan in 1966, A.I.D. withheld $2.5 million (one-third of one-half of $15 million). Performance did not improve sufficiently in the next few months, so the $2.5 million was deobligated. No other deobs have occured but the criteria for release of the second tranche of the third program loan were renegotiated and applied to mid-1968 performance when not all end-of-1967 targets were met. All criteria for release of the other tranches of the three loans have been met successfully.

This tight loan conditioning system is only a part of the Korean experience. The larger, though declining, SA commodity assistance grant program has been conditioned since 1962-63, and disbursements have been made in tranches tied, in varying degrees, to Korean stabilization performance. In the SA case the umbrella condition has been implementation of a formal stabilization program negotiated in the beginning of the calendar year. Quarterly and annual targets were established in the stabilization agreements, though releases were not completely cycled and were not tied dollar-by-dollar to specific indicators. Some targets in the stabilization agreements were emphasized more than others, and overall performance, with the money supply as a key indicator, was judged. All SA grants -- which have run at a level at least three times the program loan level -- have been disbursed, though some tranches have been held up pending performance improvement or renegotiation of conditions. ($10 million withheld in the fall of 1967 was reconditioned on satisfactory negotiation of the 1968 stabilization program.)

In effect, the program loan piggy backs on the SA grant, emphasizing or sharpening certain "key" policies explicit or implicit in the stabilization agreement. The release of the loan funds has been clearly linked to performance. The grants have had other important purposes, such as covering critical short-term import flows and providing local currency support for the Korean military budget, so some SA funds have been released regardless of performance.

Self-help performance has significantly increased since the election in 1963, and overall performance has been outstanding, with GNP growth averaging some 10 percent per year. President Park's government adopted an anti-inflation policy which has been carried out on a sustained and fairly successful basis. American influence on Korean policy is obvious, through not all of it may be attributed to the program loan, which has represented a small proportion of U. S. non-project assistance and an even smaller proportion of the total aid program. The quality of U. S. technical advice and American goodwill with the ROKG are other important elements in the leverage picture. Yet, the program loan provided a marginal incentive element of assistance to induce the Koreans to reach for high goals, ones they probably would not have met without the program loan system. Important instances of leverage attributable to the program loan conditions include the major interest rate reform of September 1965 and the impressive revenue jump in CY 1966.

The IMF has played a secondary role in the conditioning process, but will become more important as U. S. assistance phases out. A Consultative Group exists but has not played a major role.

IV. THE PRINCIPAL ISSUES

A. Did A.I.D. try to use the program loan to influence policy?

Some critics of A.I.D.'s ideology argue that in practice A.I.D. has been interested in the program loan primarily as a convenient way of transferring resources and has generally not used it for leverage, except to ensure implementation of the import program according to U. S. law. They cite as examples "unconditioned" loans, made without any strings attached, and "conditioned" loans whose conditions were not rigcrously applied.

Such critics usually have one or more of the NESA countries in mind, and frequently are thinking of a period at least three years in the past. We find that this argument does not apply to Latin America or Korea, and does not even apply to NESA anymore.

In Latin America, serious attempts to obtain leverage seem to have begun in FY 1963, in Brazil. The Colombia Mission picked up the new theme and developed it further. Program lending in Chile has followed a similar pattern. LA has usually been tough in both negotiations and performance reviews, frequently delaying tranche releases and even deobligating money committed earlier in Colombia. It is true that there have been instances in which tranches were released even though the host government failed quantitative tests and performed poorly in qualitative areas. But A.I.D. has stood firm on enough "fighting issues" to establish a credible leverage position, at least on stabilization policy. This is true of Korea as well. In Tunisia conditions were not applied in the first two years after the conversion from SA to DL, but after FY 1964 the process was tightened and by FY 1966 it included some quantitative tests and tranche reviews.

NESA has not used the program loan for leverage the way it is used elsewhere. A tranche system with quantitative tests was instituted in Turkey in FY 1966 and FY 1967, but does not appear to have been followed rigorously. Tranches have never been used in India and Pakistan. Only Pakistan was asked to sign bilateral agreements on loan conditions, and the number of those conditions was then only two. A variety of factors explain NESA's style. First, both Turkey and Pakistan were "conversion" countries -- they had enjoyed politically motivated, economically unconditioned balance of payments support via SA grants in the pre-DL period -- and it took time for negotiators on both sides to adjust to stiffer ground rules. Second, program aid to both India and Pakistan is organized under IBRD consortia, and A.I.D. has preferred to frame the self-help conditioning process in multilateral terms (the OECD Turkey Consortium and the IBRD Tunisia Consultative Groups are apparently much weaker arrangements for applying leverage). Third, at least in Pakistan and Turkey there seems to have been some feeling that the country was doing well enough without leverage, and that the program loan could be justified as a reward for past performance instead of an instrument to induce future performance. Fourth, inflation has not been a problem in the NESA countries, and there was generally little need for either major stabilization programs or the intensive, continuing surveillance process which of necessity characterized the Latin American conditioning system. Finally, some people in NESA are convinced that the more formal and mechanical elements of aid conditioning as practiced in Latin America are irrelevant at best, impolitic and self-defeating at worst. NESA prefers to use informal and multilateral methods. It emphasizes the "continuing dialogue" in place of the explicitly conditioned loan or tranche. As we will explain later in this paper, we regard the NESA system as another way of obtaining influence, rather than an absence of influence. It is, however, a more difficult form to evaluate. The fundamental difference from the LA system is that the latter tries to exert leverage at two stages, negotiation and performance review prior to tranche release. In NESA there is just the negotiation. Often, the agreement is finalized only after the prescribed policies have been adopted. Once the loan is signed, disbursement is inevitable.

B. Did the recipients perform?

The policy measures A.I.D. has tried to get program loan countries to undertake each have a chain of consequences, stretching all the way from enunciation of a policy to the effect on the ultimate economic, social, and political goals. Performance can be gauged at any point along the causal chain. Normally, when we look at the earlier links in the chain we say we are measuring self-help (i.e. the actions of the LDC government to influence those variables in the development process which it can influence).

Compared to the LDC average, the eight program loan countries as a group seem to have done relatively well on self-help. Whereas one might quarrel with the relative emphasis each gave to stabilization, growth, and distributional objectives -- as well as to the specific policies followed -- each of the eight governments pursued policies aimed at long-term improvement in the public welfare. They all justified their inclusion in A.I.D.'s list of "concentration countries." They all exhibited a serious development intent.

Beyond the question of intent, one seeks a standard for evaluating their performance. One measure close to the self-help end of the causal chain is their ability to attain targets specified in program loan negotiations. Here the record is highly mixed. In Latin America, where A.I.D. has set explicit conditions on a wide-range of stabilization and growth policies, we find hits predominating but misses far from rare. The latter have been frequent and serious enough to prompt several interruptions in aid flows, and even a few breakdowns in U. S.-recipient aid relations. In Korea, A.I.D.'s conditions have been reasonably well satisfied. Pakistan's liberalization program was successful up until the war, and has now been restored and extended. But in India, where liberalization was singled out for special emphasis in bilateral negotiations, and in Turkey, where foreign exchange earnings, liberalization, and devaluation have received continuing emphasis, results have generally been more modest.* Finally in Tunisia, the stated targets -- increasing reserves and finding another donor of last resort -- were never achieved, though a number of subsidiary, and perhaps more practicable, goals were.

Sustained self-help (if it involves choice of the right policy measures) must eventually result in high levels of achievement of a country's ultimate goals, at least relative to limits imposed by exogenous forces. If the growth

*In contrast, the fertilizer programs in both Pakistan and India appear to have been successful.

rate of GNP is taken as the measure of ultimate performance the program loan countries do not emerge as uniformly impressive performers. Only three of them -- Korea, Turkey, and Pakistan -- are above the LDC average for the 1962-67 period, although five -- Brazil, Chile, Colombia, Turkey, and Korea -- did improve their performance over that period. India and Tunisia have performed unevenly during the last three years, largely because of exogenous forces. Pakistan has slipped from its outstanding record before its war with India. Macroeconomic indicators, however, fail to identify clearly the government's contribution to development. Nor do they reflect recent institutional, attitudinal, and policy reforms whose economic effects are apparent only after a lag. Taking such changes into account, the performance records of our eight countries are all at least moderately encouraging.

C. Did A.I.D. Influence Policy?

There is no conclusive way to determine whether given host government actions are attributable to U. S. leverage. Other possible explanations are that:

(1) the host government was planning to do it anyway;

(2) the U. S. simply persuaded the host government to do it (i.e. we were the cause of the action, but we could have achieved it without a loan);

(3) the U. S. directly financed it;

(4) other donors or international bodies brought it about, through persuasion, leverage, or direct financing.

In practice, these causal forces are often so tightly intertwined that the analyst cannot possibly unravel them. If the local planning commission, a team from the IBRD, and the USAID staff have all been urging a given action which is then undertaken, who can say which elements of support were essential and which merely incidental?

Host government initiatives. One hears the comment that a donor can't get a government to do anything it doesn't want to do. A more plausible variant of this is the assertion that at least some group in the host government must favor the action the donor is urging. Even so, we argue that most possible prescriptions are somewhere on the host country's list of priorities, and most have at least some internal support. By lowering the cost of a prescription, or simply making a persuasive case on its behalf, the donor can help realign priorities. Moreover, the donor can focus attention on issues hitherto suppressed not for want of supporters but simply for lack of exposure. Thus we feel that, in principle, a donor can influence country priorities, timing and policies. And in practice we think A.I.D. has. There are too many changes on too many fronts aggressively pushed by A.I.D. in Brazil, Chile, Colombia, Tunisia, Korea, India, Pakistan and Turkey for us to suppose they would all have happened anyway. And there are several important instances where we are sure they would not have happened without A.I.D.'s influence. These occurrences, which are documented in the country papers, are the best evidence we know -- albeit circumstantial evidence -- that A.I.D. has actually achieved leverage.

At the same time, we do not mean to belittle other means of influence.

Persuasion. One also hears that any influence A.I.D. may have had is attributable not to leverage from the program but to good relations between A.I.D. and government officials. Where the Mission Director has strong contacts with the Ministries, and where the Mission's negotiating and review staff are respected by their counterparts, the possibility of bringing about policy changes through persuasion is increased. We accept this proposition, but also see its limitations. Friendship is not a substitute for a program. Nor can goodwill do everything millions of aid dollars can do. But goodwill does have a value, both by itself and as an adjunct to leverage. Sometimes changes can be effected through persuasion alone; whether the U. S. makes a program loan or not is irrelevant. At other times the fact that a loan has to be negotiated opens up discussion in which the U. S. side is able to persuade the other side of the merits of a particular policy; in this case although no leverage has been applied the loan is a key element in the policy change. Finally, there is the case in which aid is genuinely conditioned and the host government adopts the policy because it has been convinced that it must do so to get the loan. Some observors vigorously argue that this kind of assent is worthless unless the recipient genuinely believes in the course he has agreed to follow. If he has not been persuaded, they say, he will fritter away the agreement in half-hearted implementation. While agreeing that persuasion is a desirable complement to leverage, we would not go this far. We believe that leaders of developing countries are capable of balancing considerations off against each other and agreeing to take actions they are less than enthusiastic about if they are convinced that they must in order to obtain more aid. And we think that non-performance of agreed conditions can be forestalled by conscientious performance reviews tied to tranche releases of new loan signings. Moreover, there are several important instances when lukewarm acceptance of A.I.D. recommendations has shifted to vigorous support as the benefits materialized.

Direct finance. As noted in Part II, above, A.I.D. comes close to financing some program loan conditions directly (e.g., import liberalization). However, even this kind of condition is often far from painless. And most loan conditions are not of this sort anyway. They remain difficult things for the host government to do, even when A.I.D. provides some form of indirect compensation.

Other donors and organizations. Other foreign aid agencies have played a role in all eight of our countries, through the use of persuasion, leverage, and direct financing. However, we must carefully distinguish between their own initiatives and the U. S. Government's use of them as a means for achieving its own objectives at reduced diplomatic cost. (One must distinguish, that is, in principle; in particular instances it is often hard to tell who is leading and who is following).

The IMF has played a decisive role in formulating stabilization policy in Colombia, Brazil, Tunisia, Turkey and Pakistan. A.I.D. has consistently supported IMF recommendations, lending them far more weight than they otherwise would have had. On the other hand, the Fund's presence has relieved A.I.D. of much difficult and occasionally disagreeable work in a major area of policy. In Latin America, the IMF has been less popular and A.I.D. has sometimes (but not consistently) reacted by partially disassociating itself from the Fund's recommendations or by performing the overall advisory role when IMF support was not required.

The IBRD Consortia for India and Pakistan are other multilateral organizations which play a major leverage role. In these countries, A.I.D. has thrown most of its weight into the Consortium negotiations and reserved for bilateral negotiations only the extra stress it has given to liberalization and agricultural production. The Consortia are more clearly creatures of U. S. policy than is the IMF; it is hard to imagine them existing and exercising influence without the large U. S. contribution.

Even outside the Consortium countries the IBRD is an important source of persuasion and leverage bought with its own and others' money. It is especially influential in Tunisia and Colombia, where it backstops Consultative Groups.

However, the principal occasion for the exercise of leverage in our eight countries are A.I.D. program loans in all eight, the periodic Consortium discussions in India and Pakistan, and the IMF Stand-by negotiations in Colombia, Tunisia, Turkey, and Pakistan.

D. Can A.I.D.'s leverage be attributed specifically to the program loan?

It seems obvious to us that any leverage A.I.D. has had in the primary policy areas, at least since the conversion from SA to DL was completed in 1963, can be attributed primarily to the program loan. Sector lending is too new to have had much impact on development policy, though we expect its influence to be sizeable. Capital and technical assistance projects "tend to consume their own leverage," as one USAID official put it. PL 480 plays a significant role in India and Pakistan, but elsewhere it has generally not been used to get leverage, except occasionally with respect to agricultural policy. SA was formerly used to influence general economic policies. In Korea, it still is. But SA and DL are close substitutes in the leverage operation and whatever we learn about the effects of one should apply to the other as well. The proposition to which we subscribe is that the nonproject capital input program provides our negotiators with a ticket to the chambers where stabilization and growth policies are framed.

The NESA countries deviate from this generalization less than one might think. Particularly in India, leverage has been exerted mainly through the consortium, in the context of annual discussions about the total aid level. But the distinction between program aid and the total package has lost most of its meaning in recent years, as project lending has all but disappeared in response to overall funding reductions. What the consortia discuss, therefore, is basically program aid, including PL 480.

In summary, we have found self-help performance in policy areas stressed by A.I.D. and, having considered other possible explanations for that performance, are satisfied that part can be attributed to the leverage effect of the program loan. Exactly how much we cannot say. The most clear-cut examples are Korea, Brazil, Tunisia, and pre-war Pakistan. But the overall pattern is not particularly impressive and we think we can agree with those critics who argue that the leverage effects have sometimes been exaggerated.

The modesty of results to date is not necessarily an indictment of the principle of program loan leverage, only of A.I.D.'s practice since FY 1962. Conceivably, if circumstances propitious to influence can be clearly identified, and an improved conditioning system developed, A.I.D. can significantly increase its efficiency in influencing policy. Our next problem, then, is to ascertain whether certain conditioning systems, lending circumstances or other variables active in the past have been more conducive to influence than others.

V. DETERMINANTS OF INFLUENCE

A. The conditioning system

This may or may not be the most important determinant of leverage, but it is certainly the most controversial. The divergence in almost every characteristic of the NESA and LA systems is the heart of the controversy. It is hard to imagine how such a divergence could have grown up within a single Agency, where experiences are presumably communicated and people presumably learn from past mistakes. We find it impossible to conceive of any differences in national characteristics which would make both styles optimal in their own regions. We know that stabilization calls for a different conditioning system than development; nevertheless LA handled development and NESA handled stabilization (when it became an issue) in a manner which suggests that Bureau styles rather than problem type were the decisive influence. We reject glib generalizations to the effect that Latin Americans will sign anything, or that loan conditions cannot be imposed in countries which have had a decade of generous, untied commodity aid. We have thus regarded the NESA/LA split primarily as a confrontation of leverage strategies, and have optimistically searched for generalizations of universal value regarding relative efficiencies.

Table II attempts to highlight some of the important inter-country differences in the conditioning system, as well as the frequency with which penalties for nonperformance have been applied.

We identify four principal dimensions to the conditioning system:

(1) the explictness and specificity of the loan conditions;
(2) review and enforcement of conditions;
(3) the number of conditions;
(4) policy areas in which conditions are specified.

1. Explicitness and specificity of conditions.

By explicitness we mean the medium employed to express loan conditions. A wide variety of such media have been used in the countries we have studied. Starting at the "hard" end of the scale and working toward the "soft" end, the principal ones are:

(a) statements made directly to U.S. Government in loan agreements or supporting documents;

(b) statements to international bodies (IMF, IBRD, CIAP) which are explicitly referenced in the bilateral agreement;

(c) similar statements, implicitly regarded as part of the bilateral agreement;

(d) general public statements of the LDC government (e.g. national development plans), to which general adherence is pledged;

(e) oral statements not committed to writing or publicly announced.

TABLE II
PROGRAM LOAN CONDITIONING SYSTEM

(For explanation of columns, see notes on following page.)

		LOANS	RELEASES		CONDITIONS					PENALTIES	
		$Mill.	Loans	Tranches	Written Loan	Written Side	Verbal Bilat.	Verbal Uni.	Number Agreed (4+5)	Delays #	Deobs. $Mill.
	(Column #)	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
BRAZIL	FY 62	74.5	1+2A	2,1,1		X			14		
	FY 63	(25.5)	1	1				X			*
	FY 64	(50.0)	1	1				X			*
	FY 65	150.0	1	4	X	X			>20		
	FY 66	150.0	1	4	X	X			>20	1	
	FY 67	100.0	1	4	X	X			>20	3	
	FY 68	75.0+	1	2	X	X			>20		
CHILE	FY 63	35.0	1	3	X	X			8		
	FY 64	55.0	2	4,1	X	X			8		
	FY 65	80.0	1	4	X	X			>20	1	
	FY 66	80.0	1	4	X	X			>20	2	
	FY 67	- +									
	FY 68	15.0+	1	1	X	X			7		
COLOMBIA	FY 62	(30.0)	1	1			X		4		
	FY 63	60.0	1	2	X	X			10	1	
	FY 64	60.0	2	1,3	X	X			>20	3	10.0
	FY 65	-									*
	FY 66	65.0	1	4	X	X			>20		
	FY 67	100.0	1	4	X	X			>20	1	
	FY 68	58.0+	1	2	X	X			>20		
KOREA	FY 66	10.0	1	2	X				5		
	FY 67	15.0	1	2	X	X			3		2.5
	FY 68	10.0	1	2	X	X			4	1	
INDIA	FY 62	200.0	1	1							
	FY 63	240.0	1	1							
	FY 64	275.0	2	1,1				X			
	FY 65	190.0	1	1				X			
	FY 66	300.0++	3	1,1,1				X			
	FY 67	182.0	2	1,1				X			
	FY 68	248.0++	2	1,1				X			
PAKISTAN	FY 62	132.0	2	1,1							
	FY 63	100.5	2	1,1				X			
	FY 64	100.0	1	1				X			
	FY 65	140.0	1	1				X			
	FY 66	120.0	2	1,1	X				3		
	FY 67	70.0	1	1	X				3		
	FY 68	140.0++	2	1,1	X				2		
TURKEY	FY 63	35.0	1	1				X			
	FY 64	70.0	1	2				X			
	FY 65	80.0	1+2A	2,1,1		X		X			
	FY 66	70.0	1	2			X		15		
	FY 67	65.0	1	2			X		15		
	FY 68	40.0	1	1			X		8		
TUNISIA	FY 62	10.0	1	1				X			
	FY 63	15.0	1	1				X			
	FY 64	10.0	1	1		X			3		
	FY 65	10.0	1	1				X			
	FY 66	15.0	1	2	X	X			13		
	FY 67	15.0	1	2	X	X			15		
	FY 68	10.0	1	2	X	X			18		

TABLE II: Notes

1. Explanation of Column Headings

Column 1: Gross new obligations of program loans and (in parentheses) contingency loans. Later deobligations due to non-performance are shown in column 10, opposite the year of the original obligation. Where figures are followed by a plus "+", sector loans were also made in that year; by a double plus "++", fertilizer loans were made and are included.

Column 2: Number of Program Loan Agreements. +2A indicates that two Amendments added new funds.

Column 3: Number of tranche releases scheduled for each loan, including the first release of each loan. Where two or more figures are shown, reading from the left they refer in chronological order to separate loans or amendments. They are the scheduled number, not the actual number.

Column 4: An "X" indicates economic policy conditions on A.I.D. lending were written into the loan agreement.

Column 5: An "X" indicates economic policy conditions on A.I.D. lending were written into side letters to CIAP, IBRD, USAID, etc.

Column 6: An "X" indicates economic policy conditions on A.I.D. lending were agreed to in bilateral negotiations, but not in writing.

Column 7: An "X" indicates A.I.D. officials announced to the host government the policy areas where A.I.D. would expect to see some improvement, but no formal bilateral agreement on conditions was made.

Column 8: Approximate number of conditions on A.I.D. lending that were agreed to. Include both quantitative and qualitative conditions. Inter-country comparisons are difficult, since one USAID may squeeze into one condition several policy actions that another USAID has itemized. The recent Latin American loans have listed well over 20 conditions. We counted 73 for the FY 66 Colombia loan.

Column 9: The number of tranche releases from that year's loans that were delayed for more than two months because of poor self-help performance. Delays attributable to other factors are not included.

Column 10: The amount deobligated from the program loan because of poor self-help performance. An asterick (*) indicates that bilateral negotiations either broke down or were not started because of poor self-help performance and related factors.

2. Other Notes

Table does not include conditions agreed or announced in multilateral negotiations. The India and Pakistan IBRD consortia were the principal vehicles for the A.I.D. conditioning effort, though even the consortia never developed the formal system found elsewhere.

Conditions on lending can affect either the release of funds from the conditional loan, or the level of subsequent years' lendings. The latter is almost always the case with loans released in one action (i.e., one tranche).

> = Greater than

By <u>specificity</u> we mean the language used to express loan conditions. Conditions are all either quantifiable in principle or unquantifiable. Again ranging from hardest to softest, we see the main possibilities as:

<u>For quantifiable actions</u>

(1) directly quantified commitments:

(a) ceilings (e.g. "money supply will increase by no more than x%");

(b) floors ("the GOX's current account surplus will be at least y million pesos");

(c) sliding scales ("if the price of coffee is between x dollars and y dollars, the current account surplus will be at least z million pesos; if the price of coffee is above y dollars, the surplus will be at least z+1").

(2) unquantified commitments, supported by a mutual understanding on an equivalent quantitative target ("consumer price increases will be h[illegible] to reasonable amounts," which is mutually understood to mean 15% or less).

(3) unquantified commitment, unsupported by any mutual understanding on an equivalent quantitative target.

<u>For unquantifiable actions</u>

(1) dated commitments to take specific discrete, identifiable actions (e.g. "Parliament will pass the pending land reform bill by September 1").

(2) commitments to further continuing processes ("GOX will strengthen its development planning capacity").

(3) undated commitments to take specific actions.

Explicitness and specificity combined determine the overall formality or informality of a given set of program loan conditions. A formal set of conditions comprises a relatively unambiguous standard against which subsequent performance judgments can be made, whereas an informal set leaves much more room for interpretation and maneuver later on. Without counting the early NESA and Tunisian program loans, which were not used for leverage, the eight countries we are studying break cleanly into two distinct groups with respect to formality of the conditioning system. Table II shows quite clearly that Korea and the three Latin American countries have had relatively formal systems, Tunisia and the three NESA countries relatively informal ones. Within the formal group, the distinctive Korean system can be said to be the most formal of all, the LA system as applied in Colombia, Brazil, and Chile somewhat less so. Within the informal group, rankings are unclear, since there has been a general trend toward greater formality during the last six years, and since the three Consortia have tended to substitute for bilateral aid conditioning. However, the differences in both specificity and explicitness represented by the full sweep of this range are sizeable.

What generalizations can be made about the benefits and costs of formality in loan conditioning? For one thing, it is easy to dispose of the least formal forms of loan conditioning. If the alleged loan conditions are never written down and if they are never specified as precisely as their basic character permits, then they are not really conditions of the loan at all. The performance decision which must be made when the next tranche is due to be released or the next loan extended will in effect be made by criteria determined at that time, not in advance. (The exception to this is the rare case in which the U. S. announces unilaterally but in advance what it considers acceptable performance, and then adheres to the announced criteria.) And if the criteria for funds release are not known in advance by the LDC government they can hardly guide its policies.

At the other end of the scale, we can see shortcomings in extreme formality. The imperfect state of the economic arts is a limiting factor because unpredicted exogenous events -- or mis-predicted endogenous ones -- can turn a seemingly reasonable loan condition into an unreasonable one. Exogenous factors (weather and export prices are the two most troublesome) can be handled through the device of a sliding scale, if their effect on the system is correctly specified. But there is no defense against misspecification, as in the common case in which money supply is held to the desired magnitude but prices rise more than anticipated. More generally, extremely specific public commitments may give both parties less room for maneuver than they would like. They can rob the donor of the ability to reward "a good try" which does not quite reach the specified mark, and this in turn deprives him of the ability to use tough conditioning as an incentive device by setting conditions a bit higher than he expects actual performance to reach. What, then, is the optimal degree of formality? Or -- since formal conditioning may have political costs -- what is the minimum degree needed to make conditioning work? We think that if leverage is to be obtained the LDC government must be firmly committed -- to itself, to us, to the international agencies, and, if politics permit, in public -- to the program we have all agreed is the quid pro quo for the loan. Only if it is will proponents of the agreed program within the LDC government's own ranks be able to win out over those who question the wisdom of the program or are reluctant to pay its costs. For this kind of commitment to be obtained, the program must be definable in terms specific and explicit enough to permit a reasonably unequivocal judgment about the adequacy of performance later on. Beyond this, we find it hard to generalize. We would not say that conditions must be public or that they must be quantified, only that they be firm enough to permit a performance judgment, which in turn can influence later funding decisions.

2. Enforcement

We do not think that the questions of whether to use tranches, and, if so, how many tranches to have, are fundamental. Negotiations for new loans can in principle do anything performance reviews prior to tranche releases can do, although their potential to do so has not been fully exploited by A.I.D. so far. There is no reason why NESA, for example, could not explicitly condition negotiation of the next loan, just as explicitly as LA conditions tranches.

The frequency of tranche releases or loan negotiations should be related to the nature of the loan conditions (whether they refer to rapidly or slowly changing phenomena) and to the costs to all concerned of conducting frequent, comprehensive, ministerial-level reviews. The recent trend in LA away from quarterly reviews of all loan conditions appears well founded. At the same time, some kinds of policies, especially stabilization policies, require continuous surveillance. Where such issues are central, weekly or monthly staff-level meetings (as in Korea) are highly desirable.

The proposition has been put forth that leverage is a function less of what we ask for in the current loan than of what we have insisted upon in the past. We subscribe to it. Leverage cannot be obtained unless the threat implied in the process is made credible. The donor must in some way prove that he means business. We are tempted to conclude that A.I.D. cannot obtain significant leverage in a country until it has at least once invoked its major sanctions; non-release of a tranche or non-negotiation of a loan on schedule. A major reduction in loan levels might be an alternative. However, we can see from the experience we have studied that use of major sanctions elsewhere or employment of minor sanctions (especially judicious stalling) in the country concerned sometimes does the job. We do question whether country programs in which everything seems to come off on schedule, year after year, contain genuine aid conditioning. They may possess elements of influence, but it is likely to be purely of the persuasive kind.

In establishing credibility, A.I.D. has a problem akin to that of a nuclear power. Its only real weapon is a devastating one, which has the potential of destroying all possibility of future cooperation. Yet how can it exert its power without using the bomb? The answer, of course, is to develop conventional weapons. The USAID/Korea practice of tying specified pieces of the loan to specified policy conditions is one imaginative weapon, which automatically limits the extent of its fire. Most recipients do not like this "schoolmasterish" approach, however, and most USAID's and Embassies would despair to see their own freedom thus limited. The more common approach is to rely on the arts of diplomacy -- to threaten, cajole, plead, stall -- in hopes of bringing the LDC government into line. Yet these strategems will utimately prove useless if the other side stands firm, and the decision on whether to give in or employ the ultimate weapon must then be faced. If A.I.D. gives in, its credibility and ability to exercise leverage in the future may be seriously compromised. If it stops a tranche or breaks off negotiations it creates a crisis, in which economic conditions may worsen rapidly and bargaining positions harden. Pressure builds up on both sides and one party or the other usually gives in, but sometimes not before the whole environment for cooperation and rational discourse is destroyed. It is quite a dilemma.

The only solution, easily prescribed but not so easily implemented, is to avoid crises whenever possible. To do so without jeopardizing leverage requires setting firm but fair loan conditions, with a degree of flexibility in them. Even at best, crises will occur from time to time.

3. Number of conditions

These have ranged in A.I.D. experience from one to several dozen. A Mission which is genuinely interested in influencing stabilization and growth policies soon learns that (as USAID/Colombia did) it must set numerous conditions so as to avoid the loopholes which exist in an underspecified policy package. As conditions proliferate, however, problems arise. The costs of negotiation and review rise, and it becomes harder to do the job well. More important, the meaning of performance becomes clouded. If many conditions are specified, the recipient usually fails to satisfy at least one of them. Is this grounds for withholding the tranche? If not, are two missed conditions? Or three? The concept of an agreed program which everyone understands and the recipient must implememt begins to dissolve. Of course, some conditions are more important than others. Some are "fighting issues," in behalf of which A.I.D. is prepared to employ its ultimate weapon. But many others are not. And the recipient does not always know which are which.

It is doubtful whether A.I.D. can maintain credible leverage over more than a very few issues with a single loan. Other items listed in an agreement are either there for window dressing (the host government expects to do them anyway and both sides think they would look good in the agreement) or for bluff (we want something done but are not willing to spill blood to get it done). In the latter case, A.I.D.'s real objective may be to legitimatize future discussion of the issue, in hopes of getting it done through persuasion alone.

Should window-dressing and persuasion items be included in lists of conditions, undifferentiated from fighting issues? They have been included in the past for back-patting purposes, and in an attempt to extend leverage to more areas by keeping the recipient guessing about which issues were fighting ones. But the former motive should find expression in a publicity release, not a policy document. As for bluffing, we doubt that it helps. The LDC government usually has a good idea of which things A.I.D. will fight for and which not. And even if it does not, large numbers of conditions open the door to capricious ex-post tinkering with the relative weights of various conditions, a practice which is destructive in the extreme. We feel A.I.D. should enumerate no more than 3-4 major conditions in any given loan, selected and specified in such a way that both we and the recipient realize that we will be ready to withhold our funds if they are not met.

4. Areas in which conditions are specified

There has been a great deal of confusion about the relationship between policy areas and leverage. Thus, one often hears that program loans attain leverage over macroeconomic policies, but not sectoral policies. This is often ascribed to the fact that we "talk to the Minister of Finance," and not the heads of ministries implementing sector programs. The sector loan has been advanced as a solution to this alleged shortcoming of the program loan.

We find two types of confusions to be involved in this view. One is between kinds of conditions and numbers of conditions. As just noted, if an agreement has dozens of conditions only a few can be fighting issues. In LA, these have tended to be stabilization issues. Sectoral issues, especially in agriculture and education, have been added to the agreements but have usually received short shrift in the review process and have generally resulted in a lower level of performance. We feel, however, that the reason is not that the issues are agricultural, say, but that they are considered to be subsidiary parts of a large package. We see no reason why, noting the caveat discussed below, A.I.D. could not negotiate program loans with sectoral rather than aggregate issues as their center of gravity.

This, indeed, is what the sector loan tries to do. By breaking off a piece of the program loan for separate negotiation with purely sector conditions, it accomplishes much the same objective as USAID/KOREA's practice of earmarking pieces of the program loan for release if specific conditions are attained. The sector loan (which we have not explicitly evaluated) also takes A.I.D. closer to the heart of sectoral decision-making. It is not clear just how much closer, however, since the operating ministries must still get their resources through the ministry of finance, and since they sit in on program loan discussions in the best-run programs anyway.

The second source of confusion is the tendency to ignore the important distinction between instrument and structural variables. Policy instruments are much more easily and quickly manipulated than are economic or social institutions. Most of the conditions set in the monetary and fiscal fields relate to instruments; many of those in agriculture and education are deeply structural. It is not at all fair to apply the same performance yardstick to monetary policy and agriculture, say, when the mix of conditions among instrumental and structural changes varies so widely. In general, we find that structural changes (e.g. tax reforms) are just as hard to bring off in "good" leverage areas as in "bad" ones.

Having eliminated the two main sources of confusion, we must still admit to the possibility that there are "good" and "bad" areas for exercising leverage. Contrary to the rough generalization just made, it may be that like policy measures (whether instrumental or structural) <u>are</u> easier to induce in some fields than others. Our study has not been fine enough in gauge to tell.

5. <u>Dissipation through time</u>

Another common view which we must evaluate is that capacity to exert leverage is somehow limited, and tends to diminish through time. The costs of exerting leverage, it is said, build up and make it more difficult to get leverage on each succeeding round. Gradually, it becomes a choice between giving up the attempt or continuing to move forward only at increasing political cost. Latin American experience gives some credence to this hypothesis, and the sector loan approach is partially motivated by it.

In all three of the LA countries we studied we did notice a "honeymoon effect," in which smooth relations and attainment of considerable results in the early months of a new LDC administration were followed by deteriorating performance and souring relations. Partly, this is explained by the U. S. Government's willingness to be tolerant of a new government to which it is favorably inclined (e.g. those of Lleras and Frei), a willingness which gradually dissolves as the new administration proves unable to work the miracles expected of it. In addition, however, it is clear that the program loan process, as it has been employed in Latin America, creates frictions. These frictions can build to a high level of emotionalism on both sides. Thus, the U. S. becomes disenchanted with its former best hopes, while progressive leaders such as President Lleras bitterly denounce the leverage process.

The difficult question which we feel must be addressed is whether such cumulating bad feelings are a necessary consequence of vigorous attempts to achieve leverage such as A.I.D. has undeniably made in Latin America. Is leverage, as some have said, a wasting asset? We conclude on the basis of our study that it certainly is difficult to maintain it year after year, especially in a situation in which the aid level and the recipient's expectations about future assistance remain approximately stable. In these circumstances, recipients may begin to regard the current aid level as their due and increasingly resent continued demands for performance commitments. We conclude that stability over a period of years in both the aid level and conditioning system is dangerous. It may well lead to dissipation of our leverage.

In the most favorable influence relationships, however, there is a growth in policy-making ability and susceptibility to persuasion which leads to precisely the results A.I.D. desires without the use of leverage. Program loan negotiations and reviews can be exhausting educational experiences for both staffs. They force the recipient to muster statistics never before collected, and explore policy options never before entertained. Notably in Korea and Pakistan, this educational factor has led to a secular improvement in self-help performance and a "graduation" from the need for leverage. Under favorable circumstances, this transition can be accelerated by a cut in the assistance level or formulation of an aid phase-out plan, since these can lead to a heightened appreciation of the need for self-reliance. Thus, self-help seems to have been promoted in Turkey by recent aid cuts, and in Korea by agreement on a phase-down schedule. This is not to say, of course, that all aid cuts will achieve this objective. The country must have the latent will, a fairly well-developed capacity for discretionary policy-making, and a resource gap that can be filled (but preferably only with some difficulty) at the lower aid level contemplated.

In countries which are not yet ready for the transition, we would advocate conscious attempts to keep leverage from becoming routinized. The conditioning system and even the aid level should be varied from time to time. One-time offensives of the type the IBRD launched in India in 1965-66 might be tried elsewhere. If policies are bad but little influence is possible, A.I.D. should be true to its philosophy and cut back on aid.

B. The Loan

1. Loan size

The most relevant measure of loan size for most country situations is probably percentage of annual imports financed (A more sophisticated measure, which we have not computed, is the share of non-capital goods imports other than those financed by PL 480 which the program loan finances), although share of central government receipts or share of gross investment financed might also be pertinent measures in some cases. By the import measure, the program loans to all our countries except Tunisia and Korea have been similar in size, all hovering around 10%. Thus, the experience we have examined provides little basis for evaluating the rather simple-minded hypothesis that a larger loan buys more leverage in the cross-section sense. We doubt, however, that the proposition that leverage is proportional to the size of the loan has any merit at all.

2. Direction of change in loan size

Some would expect leverage to be associated with a rising aid level. Thus, the Turkey LAS argued that increases in program aid over a level of $40 million a year could be used to buy improved policies. Here, too, we lack evidence. One major upsurge in loan size we can observe is the one in LA at the start of the Alliance. But leverage doctrine and technique were still in their infancy while this rise was occurring, so we gain no knowledge of how it might have been exploited to gain more influence. The only other notable increase occurred in India in 1966 after the war. (Table 1 on page 6 shows this to some extent, but it is clearer when loans are arranged by Indian fiscal years.) That increase definitely was accompanied by substantial policy adjustments.

We do have experience with declines in loan size to observe. In FY 67 Brazil dropped to $100 million after two years at the $150 million level. Turkey and Tunisia also suffered one-third cuts in FY 1968. In Korea, the small program loan has been held constant but SA has been progressively reduced as part of an aid phase-out plan. In at least two of these cases (Turkey and Korea) falling aid has successfully been combined with tightened conditioning and improved self-help.

Probably the most sensible thing that can be said about the leverage-loan size relationship is that it really pertains to the aid level the LDC expects. That is, we can derive leverage from upward deviations from whatever path the recipient expects aid to take -- whether level, rising, or falling. This proposition may relate more closely to the total aid package than to the program loan itself. Its converse is that there is nothing more destructive of leverage than reinforcement of the notion that a given aid level is a country's "due," regardless of its performance. The important thing is to convince the recipient that better performance means more aid than it would get otherwise.

C. Environmental influences

We have just outlined our findings on the conditioning system and the loan itself as determinants of leverage. The next step is to examine the major environmental influences which can affect the outcome -- U.S.-recipient diplomatic relations, the recipient's internal politics, unanticipated economic developments and the role of third parties (multilateralism).

1. U. S.-recipient diplomatic relations

Foreign aid and the quest for influence over the recipient's development policies take place within a much wider environment of bilateral diplomatic relations. This fact influences the leverage operation in two basic ways.

It has a passive, permissive effect, in that a basic minimum level of good relations must exist if the kind of interaction involved in leverage is to come about. No one likes to be told what to do, and a country which is overtly hostile to the U. S. for whatever reason can hardly be expected to accept the leverage relationship. At the other end of the scale, it is clear that in a country which approaches satellite status the U. S. can get almost anything done that it wants. The most common relationship is neither of these, but an arms-length relationship involving an equivocal mixture of respect, distrust, sensitivity, and other human emotions on the part of the host government. The important question is whether this environment permits the exercise of leverage. We think it does, although even our "friends" have a sizeable admixture of negative elements in their attitudes toward us, and it is important to avoid triggering these feelings. Avoiding this is simply one aspect of diplomacy.

Bilateral relations assume a much more active role in some cases. When the U. S. has much bigger relationships with an LDC than its aid relationship -- notably military or major commercial interests -- much nondevelopment give and take may impinge on the program loan bargain. If aid is seen in large part as a payment for military support, as it has been at times in Turkey, Pakistan, and Korea, the recipient will be understandably reluctant to "pay twice" for aid by taking difficult development policy steps as well. In a case such as Turkey, what seems to be unconditioned aid from a strictly developmental point of view can also be viewed as a reasonable quid pro quo in a broader deal.

The recipient country may also have broader interests which affect its response to the leverage approach. Thus a country like Brazil, which places a high value on its international credit rating for commercial reasons, may be much more willing to do the "respectable" thing than it would if its commercial interests were not involved.

2. Domestic politics

A.I.D. often asks recipients to do things whose costs are likely to be more visible in the short run than their benefits. Only a government which possesses a reasonable margin of political security can agree to such a bargain. In the common case in which the LDC government must take a series of such steps it is necessary that it be able to maintain such political security over several years' time. One is drawn almost irresistibly to the unattractive conclusion that lively democracies, in which elections are frequent, fair, and hotly contested, are poor subjects for the exercise of influence. So are countries in which military or other coups are frequent or feared. These

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points apply not only to influence but also to policy action by the LDC government in the absence of influence. The contrast between the consistent and effective policy lines taken by the Ayub and Park governments, on the one hand, and the alternating periods of progress and backsliding in Colombia and Brazil, on the other, dramatically makes this point. We would not go so far as to say democracies cannot develop so fast as authoritarian states, but of two equally dedicated recipient governments, the more authoritarian is likely to look better in a self-help review.

We have already noted that in countries where governments change frequently there is a "honeymoon effect", in which a new government is tolerantly perceived as doing well, while one that has been around two years or more is invariably regarded more critically.

Political security aside, leverage obviously cannot work if the host government lacks the administrative capacity to implement courses of action it decides upon. All LDC's have this problem to some extent, but in some countries it is so severe that it turns the influence operation into something much more similar to technical assistance. In such cases, helping the host government do what it agrees to is much more important than obtaining agreement in the first place. A.I.D. has generally chosen its program loan and "concentration" countries so as to avoid the worst manifestations of this problem, but it does confront it head-on in places such as Indonesia and the Congo.

3. <u>Economic developments</u>

Unanticipated changes in the economic environment of program lending may alter the recipient's ability or inclination to take the hard steps specified in the loan conditions. This is a good reason for USAID to allow a measure of flexibility in the standards it applies in measuring self-help performance, since quarterly reviews tied rigidly to projections made at the time of the primary negotiations may penalize where penalty is no longer warranted, or praise where performance owes less to deliberate action than to fortuitous changes in the weather or some other exogenous variable.

There is one economic factor, however, which has a more immediate impact on the amount of leverage A.I.D. can extract from any loan. It is the severity of the host country's balance of payments disequilibrium. Either because the negotiators misjudged the need for balance of payments relief, or because subsequent events undermined the assumptions underlying those judgments, there is a possibility that the donee may need the loan less, or more, than it once expected. In many cases, the need seems to have been overstated. We are surprised at how long it often takes to implement a program loan, even without penalty periods. Disbursements under the first Tunisian program loan, for example, did not start until nineteen months after it was authorized and eleven months after it was signed. Additionality problems explain the delay, but one wonders whether the urgency of the initial negotiation was exaggerated. Disbursements under the third started almost immediately after the signing. In LA, first disbursements have usually lagged the tranche releases by half a year, and another year may go by before 50% of the tranche has been disbursed. By contrast, the second Fiscal Year 1967 program

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loan to India was used to cover imports that had already been made. The point here is that the economic need for the program loan varies, but is often less immediate than the program loan papers suggest. Where the need is greater, we would expect the recipient government to be prepared to pay a higher price in terms of self-help performance, but we are also more willing to make the loan.

4. Multilateralism

We have already discussed other donors and international bodies as alternative sources of policy influence. They can also be important adjuncts to the leverage operation, as A.I.D.'s generally successful use of the IMF, the IBRD (including its consortia and consultative groups) and CIAP shows. There can be no doubt that such arrangements spread the odium of applying leverage and lessen the diplomatic costs to the U. S. However, leverage can be lost in the process if the other participants are not willing to be tough when toughness is needed. The creation of an atmosphere of cool technical objectivity in which the "right" technical policies are sought (with their political implications played down) can do much to further leverage, but the U. S. must often lend backbone to the operation.

Especially in LA, and particularly with reference to stabilization policy, the IMF has played (and sometimes overplayed) a vigorous, important role. The IBRD role in the India and Pakistan consortia has also been generally effective. In all these cases, U. S. support was a crucial ingredient. It is apparent that the failure of the donor groups for Turkey and Tunisia to develop a strong position on development policy forced A.I.D. to follow a more independent negotiating line.

D. Personal touches and the art of influence

One of the things our study has impressed strongly on our minds is the importance of the human element. Many of the observable differences in approach and degree of success among countries and between periods within countries seem attributable to variations in personality, training, and competence on the part of both U. S. and host country participants. To build effective policy influence into a program loan, we believe that the following personal traits are necessary.

The Mission Director must have a firm grasp of and deep belief in A.I.D.'s mission, in general and as applied to the host country. He must be willing and able to defend that mission against conflicting short-term political and commercial objectives of the U. S. At the same time, he must be an effective diplomatic operator vis-a-vis the host government. This requires firmness at times, but empathy and integrity throughout. He must be viewed by his Ministerial counterparts as a sympathetic man, a competent man, and a man of his word. Serious failings on any of these counts can undermine his mission. He must practice the arts of influence, which have been codified by one former Mission Director as follows:

-- If at all possible, induce the host government to put forward its program.

-- As much as possible, make aid adjustments in response to local performance look like bonuses rather than penalties.

-- Select relatively few explicit conditions, but make them key ones.

-- Work to get conditions which are genuinely accepted as valid and feasible by those who agree to them and must direct their achievement.

-- Don't bluff, at least not completely (i.e., when sanctions are threatened, make sure they can be applied, if necessary, without cutting off our own noses in the process).

-- Demonstrate faithful and consistent follow-through on the U. S. action called for by any agreements.

The Mission Staff must contain some analytical talent, which is willing and able to immerse itself deeply in the local milieu. This means it must be professionally trained, practical in approach, and free enough of implementation, reporting, and other responsibilities to devote a large block of time to policy. The size of the policy staff depends on the ambitiousness of the influence operation being attempted. For an LA-type program, 4-5 good analysts are needed.

The local counterparts must be Janus-like, looking toward the aid agencies and their own governments simultaneously. Vis-à-vis the aid agencies, they must possess the training and outlook to be receptive to rationalistic policy arguments. Vis-a-vis their colleagues in their own government, they must have the power and prestige to lend the commitments they make to the aid agencies practical significance. Outstanding influence operations in the countries we have studied have usually pivoted around a key man in the local government who possessed both these sets of traits (e.g. Roberto Campos in Brazil under Castello-Branco, Mohammed Shoab in Pakistan). Support for such men from above and below is also important. Presidents Ayub and Park are notable for the strong, continued support they have given to development. At the staff level, Pakistan and Korea also stand out for the competent economic staffs they have developed. (In Korea there has been no figure corresponding to Campos or Shoab; however, a strong Assistant Minister of Finance and the staff he has built up around him have compensated for a high rate of turnover at the Ministerial level.)

VI. CONCLUSIONS

Having come this far, we are impressed by the ambitiousness of the task we have undertaken. We feel that the specific, limited generalizations we have made above have some merit. We are not entirely confident of whether we have laid an adequate basis for the kind of grander generalizations appropriate to a conclusions section. But we do want to make four kinds of conclusion-like comments. These concern the degree of generality possible in this area, what few descriptive generalizations seem universally valid, what we have learned about program loans versus project and sector loans as vehicles for influence, and what future actions by A.I.D. seem desirable.

A. Degree of generality possible

As between the extreme of viewing the countries in our sample as undifferentiated testing grounds for the causal relations we have hypothesized and that of regarding each country as unique, we come down closer to the former. While we cannot say that the LA system, the NESA system, or any other variety of conditioning system is best for all countries at all times, we do think there are many things to be said that do apply to all countries. There is a general art or science of influence which is not invalidated by differences in national culture, politics, or economic structure.

B. Generalizations from experience

We now recapitulate what we consider to be the most important generalizations established (or at least suggested) by our study.

(1) A.I.D. has been true to its self-help philosophy in all the countries examined, at least during the second half of the 1961-68 period; this has generally been as much the case in countries in which the aid conditioning system has been subtle and implicit as in those in which it has been highly explicit.

(2) The performance of program loan countries as a group has been only about average, although it has improved during the program loan period.

(3) A.I.D. has influenced self-help and performance substantially: through direct financing, leverage, and persuasion, bilaterally and in consort with other national and international lenders.

(4) The program loan is A.I.D.'s primary instrument of leverage and persuasion, although some influence also attaches to other forms of aid and to the country assistance program as a whole.

(5) The trappings of the formal loan conditioning system, many explicit and specific conditions, frequent reviews and tranche releases, are, by themselves, irrelevant; what matters is whether the message is somehow conveyed to the recipient that the aid level depends on performance; this in turn requires only that the agreed program be described in terms specific and explicit enough to permit a reasonably unequivocal performance judgement later on, and that the agreement be enforced.

(6) Enforcement, while essential, poses difficult tactical problems because of the fact that the most effective sanction, withholding of aid, is often a devastating one; the aim thus becomes to maintain

this sanction as a credible threat without actually having to use it.

(7) Persuasion is highly preferable to leverage, although it is possible to effect policy changes without it.

(8) If real leverage is needed, it should be applied only to a very small number of areas at any one time.

(9) Any area of policy is susceptible to influence, except those which are ruled out by strongly held ideological views.

(10) At the same time, structural changes take far longer than changes in instrument variables, and due allowance should be made for this in A.I.D.'s expectations and in the conditioning system.

(11) It is hard to maintain a constant level of influence through time, especially at a constant lending level; aid cuts at the right moment can help; what is really desirable, however, is a gradual growth process in the host government, in which leverage, and eventually U. S. influence in any form, become unneeded.

(12) The most important relation between influence and loan size is that influence can be obtained from increments of aid above what the recipient expects, whatever that is.

(13) Influence can be undermined by generally hostile U.S.-host country diplomatic relations, and also by broader political, military, or commercial relations in which the quid pro quo for U. S. aid lies outside the development field.

(14) Successful loan conditioning requires a substantial degree of political and administrative strength on the part of the recipient government.

(15) Multilateralism is often useful tactically, but a strong U S. insistence on self-help is usually a necessary ingredient i. success.

(16) The human element (in the Mission Director, his staff, and their host country counterparts) is an important part of the story.

(17) For A.I.D. to presume to take positions on stabilization and development policies in a major country it must be prepared to field an excellent analytical team. This is serious business, and A.I.D.'s "intuition," and capacity for casual appraisal, are insufficient for sorting out the relative weight of the many critical variables involved.

C. Program loans vs other forms of aid

The main alternatives to program lending are project loans, sector loans, and the aid package or consortium approach. Each can be a complement to program lending as well as a substitute. Although we have looked at all of these in passing, we have not given them the attention we devoted to the program loan and thus cannot make conclusive judgments on the merits and limitations of each. However, we do have some confidence in the following remarks.

(1) Project loans are good only for a narrow range of influence, extending at best throughout the sector in which the project is located. We have not examined the few cases in which a "package of projects" approach was used (e.g. Peru), but we understand the experience has been unfavorable. We do not intend to demean the project loan as a means of financing desirable activities and exerting localized policy influence, but as a device for influencing general policies its inherent limitations -- the distracting effect of the heavy demands for analysis and negotiation of details of the project itself, the fact that project loans often do not seem to recipients to be appropriate occasions for general discussions, and the difficulty of applying sanctions for nonperformance once physical construction has begun -- are crippling.

(2) The sector loan is a new device, which we consider a promising means of focusing on frequently neglected sectoral conditions. However, there are definitional problems with sector lending, and we suggest a separate analysis of it,. including an evaluation of experience so far, in the near future.

(3) The consortium approach seems to work well if it gets motive power from its donor members and adequate staffing from its institutional sponsor. We see it as a valuable adjunct to program loan influence rather than a substitute for it. Unfortunately, this approach is in serious trouble right now because of the unwillingness of the donors to put up enough aid funds to make it work.

D. Recommendations

(1) Retain program lending as the major element in the aid package in those countries where the U. S. wants to influence broad overall policies and is willing to supply the material and human resources to succeed in this effort, and where the shape of the host government gives some hope of success.

(2) Avoid using the device (or at least the label) in countries where these conditions do not hold -- where short-term considerations dominate U. S. policy, where the U. S. is not willing to make a significant commitment, or where there is little or no hope of influencing policy.

(3) Keep policy conditions of the loan few in number; work for clear definitions of these conditions and differentiation of them from pseudo-conditions.

(4) Avoid routinization of the approach in a particular country; if other reasons for change do not present themselves, vary

the routine merely to reduce the chances that our influence will decline.

(5) Pay close attention to casting the drama: pick a Mission Director who has the qualities referred to above, give him a good economic staff, and look for the best point of contact in the host government.

(6) In countries where significant influence is successfully being wielded, work on building up the local capacity for policy formulation; think in terms of a phase-out plan for U. S. policy intervention similar to an aid phase-out plan but aimed at an earlier completion date.

APPENDIX: A Summary of Reviewers' Views

by: D. H. McClelland

This evaluation study is a statement of the views of the authors. Although they sought throughout to obtain information and opinions from most of the people in AID/W most knowledgeable on the subject, the report explicitly does not seek the least common denominator necessary for an agreed document.

The final draft (as well as earlier versions) was circulated to the Regional Bureaus and country specialists. This Appendix endeavors to summarize the general observations and criticisms received. The focus here is on qualifications and disagreements, but the tenor of most comments was clearly one of general agreement with most of the findings and conclusions of the study.

The most frequent type of comment was concerned with what the study did not do.

One important observation was that the question of whether program loans have been used to influence policy or performance is less significant than the question of how well the U. S. has been able to influence policy by the use of all of its instruments.

A still broader study aimed at the development effectiveness of U. S. policy influence would certainly have had advantages, if practicable. The study, however, considers the broader review to be unmanageable and focuses on whether and how influence has been exerted through program lending, not on the merits of the policies encouraged or the other instruments employed.

Another omission, which is perhaps inherent in the self-imposed boundaries of the study, is the limited attention given to what is perhaps the basic rationale for program lending -- the need to transfer resources in support of a development program. There is some consideration of this point in connection with import liberalization; e.g., in Pakistan, the program loan included this as a major objective and simultaneously provided at least a part of the foreign exchange necessary to achieve the objective. It is true, however, that resource transfer questions are not dealt with as an integral part of the study.

There were also comments in some cases about the very limited treatment given to Supporting Assistance. This is largely relevant in South-east and East Asia, where only Korea has had program loans, and where even in Korea, SA has been the principal instrument for achieving influence. It may be that the paper could have expanded the discussion of SA in Korea, although the study itself notes that "in effect, the program loan piggy backs on the SA grant". But the possible influence achieved by SA grants elsewhere in the area is not considered as it is beyond the scope of the study.

Another criticism was that insufficient emphasis was given to objective between the two classes of country cases grouped by "formality of the conditioning system." The study observes that Korea and the three Latin American countries have had relatively formal systems, Tunisia and the three NESA countries relatively informal ones. In the first group of countries, however, domestic stabilization conditions have been in the forefront with more general developmental policies receiving less emphasis. For the second group of countries, inflation has been a less serious problem and the objectives of program loans have focussed more on other policy questions. A case can be made that stabilization objectives lend themselves more to (and perhaps even require) specific, detailed conditions in the agreements, as in the general pattern of IMF agreements. The study does mention that this difference may explain a good part of the difference in "style" between the two groups, but some critics felt that more analysis could have been made on this point.

One commentator observed that the study did not give sufficient attention to the "art" of establishing conditions and evaluating satisfactory performance. It is argued that two conflicting biases are likely to be considered. On the one hand, the possibility of setting targets somewhat beyond the range of expected achievement may be considered to make the policy makers stretch or try harder than they otherwise would. On the other hand, there may be an incentive for Missions to "play safe" and make the conditions less rigorous than they could be in order to reduce the danger of being criticized for not meeting the targets, particularly should the shortfalls be due to conditions beyond the control of the government. No very definitive treatment of these considerations is possible within the limits of this, or perhaps any, study. Even so, they do qualify any findings about successes or shortfalls in achieving targets.

In addition to these suggested qualifications of the study for what it did not do, there were two major criticisms of the findings themselves.

One criticism was the inadequate weight given to the importance of "the continuity in financial support required to achieve certain policy objectives." It is argued that a combination of objectives such as priority to agriculture, devaluation, import liberalization and market oriented investment decisions cannot and should not be renegotiated annually, and that it is not necessary that each loan "get" something. While the difference here is one of degree, there does appear to be a real difference of opinion as to how explicitly and repeatedly the potential leverage of program lending should be exploited.

The other specific disagreement was a more narrow one related to the primacy of program loans in obtaining leverage. While agreeing that A.I.D. leverage in the primary policy areas can be primarily attributed to Program

Loans, the criticism suggested that the statements on the usefulness of PL 480 and Capital and Technical Assistance projects in influencing primary policy areas appears to give too little weight to them.

These suggestions of possible errors of omission and commission, although important, do not appear to bulk large in terms of the whole study. Although the final review process requested only comments and not concurrence, the fact that the number of major criticisms was small suggests a fairly general agreement, in broad outline if not in all details, with most of the findings of the study. And it is important to note that there was no dissent expressed on the central conclusions that A.I.D. has exerted considerable influence over policy and that the program loan is A.I.D.'s primary instrument of leverage and persuasion.

THE USE OF PROGRAM LOANS TO INFLUENCE POLICY

PART 2.: COUNTRY STUDIES

UNCLASSIFIED

CONFIDENTIAL

BRAZIL

by

Edward B. Rice

with the assistance of

Carl J. Hemmer

March 1970

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PROGRAM LOAN STUDY: BRAZIL

Page

I. INTRODUCTION

A.I.D. has signed five program loan agreements with Brazil, the first in FY 62 and the others in FY 65, 66, 67 and 68. The FY 68 program loan package includes, for the first time, several sector loans (which still await signature). All of these loans including the first were to be provided in tranches whose release was conditioned upon the implementation of stabilization policies and the achievement of quantitative stability targets. With the FY 65 and later loans, quarterly pre-release reviews of progress were instituted and a group of agricultural and other sectoral development policies were added to the list of indicators. The gap in FY 63 and FY 64 resulted from the breakdown of negotiations with President Goulart's administration over stabilization policy. Smaller, contingency loans were authorized without conditions in those two years. Full-scale negotiations on DL non-project assistance did not resume until after the revolution in March 1964 and the assumption of power by Castello-Branco.

A.I.D. experience in Brazil must be evaluated against the backdrop of an extremely unstable political scene. Negotiations have been conducted with four different regimes within seven years and with a score of government officials whose tenure for effecting agreements was quite uncertain.

Brazil, with a population of 87 million, has received less U. S. loan aid, or program loan aid, per capita than either Chile or Colombia (the ratios are 2: 6: 3), but twice as much as Pakistan and four times as much as India. A more instructive statistic is the ratio of program loans to imports. Brazilian imports ran at a level of about $1,400 million during the 1960's. Thus A.I.D. program loans have covered a little less than 10% of the import bill since 1965. This is the same order of magnitude as the Chilean and Colombian program loan coverage, and, for that matter, of the Indian and Turkish coverage. It is less than in Pakistan (16%) and more than Tunisia (5%).

II. CHRONOLOGICAL SUMMARY OF BRAZILIAN EXPERIENCE

A. Summary of U. S. and other donor assistance

Before 1961 the U. S. program in Brazil consisted of a large technical assistance operation, minor PL 480 Title III deliveries, and Ex-Im Bank loans averaging $100 million per annum. A Title I food program was initiated in FY 1961 which ran for four years, stopped, started (FY 66), and stopped again. It does not appear to have played a major role in the negotiation process.

The Development Loan program in Brazil was kicked-off with President Kennedy's commitment to President Quadros in March 1961. The first loan was the FY 62 program loan for $74.5 million, released in four successive steps. Two contingency loans provided some non-project dollar aid in FY 63 and FY 64, when negotiations over DL program loan conditions broke down. In FY 65 the DL Program Loan operation moved into high gear and ever since the Program Loan negotiations have been the focal point of USAID strategy in Brazil. Project loans began in FY 63, when $37 million was obligated. They have continued at a substantially higher rate ever since, though still less than the program loan rate.

The FY 65 Program Loan totalled $150 million, FY 66 $150 million, FY 67 $100 million (only $50 million of which was released), and the FY 68 package $170 million (including $50 million FY 67 carry over and $45 million in sector loans). These program loan amounts compare with annual averages since FY 64 of $75 million for project loans, $13 million for technical assistance and $15 million for Export-Import credits. The dominance of the program loan is obvious, but it is equally apparent that project loans and technical operations continue to make substantial contributions, and have done so even in years when the program loan negotiations ran into difficulty. Indeed in the FY 65 CAP submitted in November 1963, the expressed USAID strategy was to take advantage of the large project loan component* to exert influence on official Brazilian policy, since a program loan did not appear to be negotiable at the time.

U. S. aid in recent years has exceeded the combined total of other donor aid, though not by much. In the three year period FY 65-FY 67 obligations of the international institutions -- IBRD, IDA, IFC, and IDB (including SPTF) -- totalled $560 million, compared with AID DL obligations of $650. Other bilateral aid amounted to $150 during the same period. No consortium arrangement exists, though USAID has been pushing Brazil to persuade IBRD to expand its loose multidonor arrangements in the transport sector into a wider and more formal device. The Brazil-IMF relationship has been stormy but productive. An IMF Stand -by Agreement in 1961 scured after only $60 of $160 million had been used. New Stand-bys were granted in FY 65 and each year thereafter, but neither Brazil nor IMF have been always happy with each other since 1961 and only U. S. insistence on an IMF role in the stabilization program joined to Brazil's desire for an acceptable credit rating in the international community has kept them together on occasion.

B. FY 62: $100 million authorized, $74.5 million released.

President Kennedy had promised President Quadros in March 1961 $100 million of A.I.D. funds as part of a U. S. package. Disbursement was generally understood to be conditioned on the success of a stabilization program which the Quadros Administration was putting together with IMF support. Quadros' sudden resignation in August contributed to a fiscal and credit crisis upon which the stabilization program foundered. Despite an obvious lack of progress, but in an effort to give the new President Goulart the benefit of the doubt in his announced intention to salvage the

*Most of those project loans were directed to particular regions, however, particularly the North East.

stabilization platform, AID proceeded to obligate part of the $100 million. In four separate actions between October and May 1962. $74.5 million was released ($30, $20, $15, $9.5).

The use of conditions accelerated in that period. The first $50 million was released with only general reference to U. S. expectations that the essential elements of the IMF stabilization plan would be respected -- reduction of the federal cash budget deficit and restraint in official credit to the private sector. The third release, however, was conditioned upon GOB acceptance of a new IMF visit. The fourth was delayed four months while Goulart's finance officers and the IMF team prepared a new stabilization plan. The release -- a modest one of $9.5 million -- followed announcement of the new plan and an exchange of letters between Finance Minister Salles and the U. S. Secretary of the Treasury conditioning further obligations under the original Kennedy commitment to the successful processing of the new austerity measures and progress toward quantitative targets. The latter included explicit ceilings on the cash budget deficit, Executive Office expenditures, cash transfers to the railroad and other parastatal transport entities (the "Autarquia"), and Bank of Brazil rediscounts and credit to the private sector. Other parts of the program included tax reform and more flexible and timely manipulation of commercial bank reserve requirements and foreign exchange rates. The thrust of the 1962 stabilization program was against inflation, and its principal chapters -- on the federal budget deficit, the Autarquia deficits, official credit to the private sector, and exchange reserves -- were to remain the centerpiece of USAID program loan negotiations (together with the handling of the coffee fund, which was first emphasized in the FY 63 negotiations) until the present.

The 1962 stabilization plan never got off the ground. For various reasons Goulart refused to take the decisive and generally unpopular actions called for under the plan. The political situation was confused throughout CY 1962, with the President struggling to establish an extreme leftist regime and business and some military interests trying to thwart him. Further disbursements of the $100 million loan under the original DL program were abandoned.

C. <u>FY 63: $25.5 million (Contingency) authorized and released</u>

In early 1963, Dantas, the new Finance Minister, visited Washington in hopes of working out a new agreement. Negotiations were successful and, in an exchange of letters between Dantas and Administrator Bell, a new A.I.D. commitment was made. It was conditioned upon a series of self-help stabilization measures comparable to the 1962 plan. One of the explicit targets was that a new IMF agreement should be reached by June 1963. The U. S. package included the release of $84 million funds remaining from the 1961 commitment ($25.5 million of which were A.I.D.) and over $300 million of new money to be spent over two fiscal years FY 63 and FY 64.

In April, A.I.D. fulfilled an understanding of the Bell-Dantas agreement by obligating $25.5 million. Shortly thereafter it became obvious that Goulart was not prepared to support Dantas' plan; in fact Dantas was replaced in June. The projected IMF visit never materialized, and the agreement in effect was terminated. USAID was careful not to close the door. It continued to assert to the GOB officials that large program loan reserves could be made available provided self-help stabilization conditions were taken seriously. However, at the political level U. S.-Brazilian relations were suffering from increasingly outspoken criticism of U. S. international objectives on the part of some of Goulart's team, and the U. S. Government was increasingly disturbed by the growing Communist influence in Goulart's regime.

D. FY 64: $50 million (Contingency) authorized and released

While Goulart was in power, formal program loan negotiations were not resumed. The FY 65 CAP submitted in November 1963 identified the types of self-help criteria against which USAID measured Brazil's credit worthiness -- emphasizing the same points as the unsuccessful 1962 and 1963 stabilization plans -- but the GOB was not interested in meeting them.

The revolution, and Castello-Branco's accession in April 1964, completely changed the picture. Various actions, including the appointment of Roberto Campos as economic minister suggested that the new administration intended to get tough with inflation. As a support for debt rescheduling agreements, an interim contingency loan of $50 million was approved in June 1964, and contacts proliferated in the process of working out a new donor-recipient review mechanism upon which a larger and continuing program loan series could be based.

The evaluation of the leverage effects of program loan experience in Brazil through FY 64 shows that U. S. attempts to use generous balance of payments support to influence stabilization policy during the Quadros and Goulart Administrations failed. But it is also true that U. S. refusal to proceed with loan disbursements contributed to Goulart's increasingly indefensible fiscal, monetary and foreign exchange position, and that the evident U. S. preparedness to resume a loan program once stability conditions were met probably led Goulart's critics to believe that revolution, if followed by vigorous corrective measures, would be financed.

E. FY 65: $150 million authorized and released

In December 1964 the first of the "modern" program loan agreements was reached. It called for the immediate release of $52.5 million (conditioned, in retrospect, upon an impressive number of institutional reforms and policy changes adopted in late CY 1964, including the halving of Goulart's projected budget deficit, creation of a Central Bank, development of major tax reform legislation, railroad rate increases, and a much tougher position vis-a-vis the coffee growers) and three subsequent releases that were to follow quarterly reviews of progress toward explicit quantitative indicators and qualitative measures of reform. The quantitative indicators were accepted by both sides as the fundamental test of progress. As in earlier years these indicators placed ceilings on the cash budget deficit, transfers to the Autarquias, and official credit to the private sector. They also allowed for no deterioration in public holdings of foreign reserves. The qualitative indicators involved other fiscal, monetary and balance of payments corrective devices, as well as special treatment of the sensitive wage and coffee support issues. In addition to these stabilization conditions, a few qualitative indicators of progress in development planning and agricultural production were thrown into the agreement.

The quantitative and qualitative targets were described in detail only in the GOB's letter to the Chairman of CIAP. The Loan Agreement and initial implementation letter referred in summary fashion to those targets, emphasizing the quantitative tests and the few qualitative measures in which the U. S. was particularly interested. They also described the review process and anticipated timing of tranche releases. Occasionally an agreement too sensitive to be publicized in the CIAP letter -- for example on coffee pricing policy -- would be handled in side-agreements and formally mentioned only in the implementation letters.

The review and release of the FY 65 loan tranches proceeded smoothly. A slight delay in the release of the second and third tranches can be attributed to the problems that the GOB statisticians and economists initially experienced in preparing the requisite data. The fourth tranche was released in December 14, 1965, two and one-half months after the end of the quarter being reviewed and only one and one-half months after the implementation letter predicted it would be released 11 months earlier. All of the quantitative targets were met as stipulated in the original CIAP letter. A most welcome sign was the strong recovery of foreign reserves. The significance of the credit ceilings was thrown into doubt because the money supply and the price level increased well beyond the levels which were thought to be implicit in the USAID credit tests. (The FY 66 loan agreement on monetary policy was written with a more specific indicator). Because of a shortfall in coffee earnings, the coffee fund ended in deficit rather than surplus. Slippage occurred in other qualitative measures, but in general the GOB's program and the leverage exercise were considered a success.

F. FY 66: $150 million authorized and released

The FY 66 program loan was signed in February 1966. The format was the same as the FY 65 loan -- tranche releases were conditioned upon progress, reviewed quarterly, toward quantitative and qualitative targets described in the GOB's annual submission to CIAP. In three respects the latter changed slightly. First it refined the monetary indicator for official net domestic assets, a final line item appearing in a new "monetary budget" designed jointly by GOB and IMF and the major negotiating document for IMF Stand-bys. Second, a strong coffee price policy (covering the prices paid by the GOB Coffee Authority to exporters and producers out of export earnings) was covered in a side agreement. Third, there was an enormous expansion of conditions concerning sectoral development policies. These were admittedly weaker, qualitative, conditions, but they announced a series of reforms and improvements in education, agriculture, and housing which presumably the U. S. was prepared to follow closely in determining whether to proceed with tranche releases.

The FY 66 loan was in trouble even before it started. A sudden surge of liquidity in the last quarter of CY 1965, which was not picked up in the statistics until after the monetary targets for December 31, 1965 had been established, made it virtually impossible to meet those conditions. The liquidity situation improved by March and again by June, but not before it had spilled over into the import register and helped occasion a disturbing loss of reserves. By June, a serious credit and exchange crisis was in the making. The review of the first CY 1966 quarter, which was supposed to have been over in time for a May release of the second tranche, was prolonged till July 29 while USAID and AID/W officials hammered out with the Brazilian officials a new monetary plan for the second half of CY 1966. A letter from the then Finance Minister Bulhoes stated the new targets, which were adopted as the new conditions for tranche releases. The second tranche was delivered in August, three months behind schedule, followed shortly by the third. The economic results of the adjustment were satisfying, since reserves recovered and the new monetary targets were easily met.

The fourth and final tranche of FY 66 was also delayed. The problem now came from the fiscal indicators, which previously had been performing splendidly. Transfers to the Autarquia and the cash budget deficit both exceeded their ceilings. These excesses were excused on the basis that the overall federal account was in surplus -- a new experience in recent history -- and that the transfers and budget deficits, while excessive, were substantially below 1965. The fourth tranche was released in February 1967, three months late.

One of the principal subjects of discussion throughout CY 1966 was coffee price policy. The mechanism for quantifying coffee support price policy was the surplus on the coffee account in the monetary budget. The initial implementation letter referred to an oral understanding that the nominal coffee price would be held constant, implying a fall in the real return. The reference was shortly thereafter deleted. But/Castelo-Branco was firm with the coffee producers and exporters during the year and the fund made a contribution to deflationary policy by showing a healthy surplus. At the same time the coffee eradication and diversification programs proceeded twice as fast as expected. U.S. negotiators had taken a prime interest in encouraging Castello-Branco's coffee policy and have taken some credit for its success.

Towards the end of 1966, the Mission took a firm stand on import liberalization, and persuaded Campos to take immediate and effective action. The effective tariff rates were cut by 70% or more. While the Mission's concern for additionality was self evident, its position on liberalization reflected a genuine U.S. interest in freeing the Brazilian import regime and providing a stimulating environment for the Brazilian private sector.

The development targets in education, agriculture and housing were not stressed in the quarterly reviews. The airgram dispatches covering the reviews mention some misses, and only a few significant success stories. Progress in these areas obviously did not trigger the tranche release mechanism, but it is clear that failure would not have delayed it. It is relevant, however, that the Brazil USAID Mission Director we interviewed feels that the reorientation of public policy toward price parity for farmers and the development of rural incentive programs is one of the most significant leverage effects A.I.D. can claim in Brazil. These price and incentive programs were part of the FY 66 program loan agreement, and one should probably have to attribute part of the leverage he spoke of to the program loan, not withstanding the influence specific project loans and technical assistance projects were having in the same direction. This is instructive, since it shows that A.I.D. may get important leverage effects in areas other than those highlighted by the quarterly review mechanism.

G. FY 67: $100 million authorized, $50 million released

The FY 67 negotiations were held with the Castello-Branco Administration, although the job of a carrying out the program after March 1967 would fall to Costa e Silva. The early negotiation was preferred to either a two step discussion or postponement because it emphasized continuity in basic policy and because Costa e Silva, during a stopover in Washington, had expressed his intention to implement his predecessor's agreements. But the negotiated conditions were soon outdated by the developing recession and fiscal crisis. Moreover, some of the principal stars in the Castello-Branco constellation unexpectedly disappeared, including the President of the Central Bank, and the new finance minister had a very different "style" of operation. Continuity was thus not perserved, and the problem of implementing the FY 67 loan mounted. In effect, it had to be aborted after the first $25 million tranche was released.

The format and review arrangements were almost identical with the FY 66 loan. The first review, held in April to cover the October-December 1966 quarter, noted with satisfaction the recovery of monetary indicators and foreign reserves. It noted also the continuing excesses in fiscal policy but again excused them on the basis of their favorable relation with 1965. By this time, however, Costa e Silva was in power, and it had begun to appear as if either through indecision or intent he was not prepared firmly to pursue the stabilization program. USAID held back on the first tranche. When the tranche was finally released in July, four and one-half months late, it was already clear that the agreement would have to be substantially rewritten. In short, what had happened was that Costa e Silva did not act to correct the growing inbalance inherited in the budget and did, deliberately, violate the credit prescription in the hopes of ending the industrial recession around Sao Paulo. Liquidity built up and the foreign balance, aggravated by speculative capital movements, began to deteriorate. A contributing element was the inflationary settlement Costa e Silva presented to the coffee interests in June, (although owing to the reduced crop, the year end coffee account was contractionary compared to the preceding year).

A review session begun in June to cover the January-March quarter reported that major indicators had been violated. USAID and GOB attempted to develop a new program in July, but it did not work. Actually it was only premature. The new President and his young Finance Minister (Delfim Neto) began to tighten the screws in the last semester of CY 1967. Fiscal performance improved substantially in the third quarter. They waited longer to apply the brakes to credit policy, but most observers by then were admitting that despite its initial hesitancy and indulgence, the new Administration was probably as serious about stabilization as its predecessor.

Delfim Neto visited Washington in December 1967, and was told that any further tranche releases depended upon resolving exchange rate prices and the attendant exchange speculation, as well as adoption of some additional credit control to sop up the considerable expansion which had already taken place. Shortly after his return, devaluation was carried out and some controls were instituted. USAID was satisfied with the performance and proceeded to release the second tranche of $25 million in early February 1968 and started serious negotiations over the FY 68 program.

The FY 67 program loan reviews do not discuss the qualitative conditions. The violation of the quantitative indicators washed out any consideration of performance in the other areas. Thus it is not clear whether the sectoral program described in the CIAP letter (which, incidently, were expanded to include health projects) proceeded at an acceptable rate. The impression one gets from those officials who argue for sectoral loans is that the program loan was tested and found to be a poor vehicle for sectoral reform, with the exception perhaps of coffee policy. In general, too many conditions were attached to the annual program loan to permit an effective concentration on sectoral problems. Overall, however, progress in agriculture was quite good.

The previous discussion ignores several administrative reforms which had been referred to in almost all the program loans but had not been considered critical to tranche release. They were ignored not because of any lack of importance to overall stabilization and development policy, but because it was impossible to compute a timetable of progress. Legislation was usually required and the reforms were understood to require many years. In four areas -- tax reform, budget control, the administration of the Autarquia, and import liberalization -- the GOB had gradually accomplished a great deal.

The link between U.S. influence and these reforms is not hard to trace. USAID's insistence on including them in the annual negotiations and lists of conditions prodded the GOB to move faster than it would have otherwise. Some of the problems that appeared in the quantitative indicators in 1967 were indirect results of these successes in the qualitative measures. In particular the new tax system which was imposed with USAID blessing in early CY 1967, a system which redirected some revenue to local government authorities, had not proceeded as expeditiously as expected. The local authorities needed temporary financial support from the federal government, which aggravated the latter's own fiscal woes and contributed to the excessive build-up in the money supply. Second, the increasingly flexible import controls system made it all the more likely that excess domestic liquidity would spill over onto imports. Prior to signing the 1967 Loan, the U.S. negotiators insisted on some form of liberalization. The result was a striking reduction of effective tariffs from 100% to 30%, and an increased exposure of the Balance of Payments to domestic market forces.

H. FY 68: $125 million, plus $45 million in sector loans

The FY 68 package includes $75 million of new obligations and the $50 million carryover from FY 67. In an attempt to get greater leverage on sectoral program, sectoral development targets will be tied to the sector loans and not to the program loans. Presumably a shortfall in sectoral accomplishments could lead to delays in disbursement of the sector loans. Under the old system, where sectoral conditions were attached to the program loan, such shortfalls did not influence the tranche release process, and conversely, as the argument goes, the tranche release process did not provide leverage on sectoral policies.

The draft negotiating instructions for the A.I.D. team were prepared in January 1968. Substantial agreement had been reached with the GOB by April, but there was some problem in getting clearance from all of Costa e Silva's principal officers on the letter to CIAP. The new Agreement, and the release of the $50 million carry over, were made in late May. AID/W officials are confident that the Costa e Silva Administration intends to pursue the agreed stabilization plan vigorously.

The most outstanding recent development has been the flexible exchange rate system decreed in August 1968. The system is designed to discourage the speculation experienced in the past. A.I.D. pressed for such a system beginning in February, but without making its adoption an explicit condition for assistance. Delfim Neto favored the idea but other GOB officials were opposed. The serious reserve losses of June through August finally moved the government to adopt the change, and the new system has worked very well so far.

III THE PRINCIPAL ISSUES

A. Did A.I.D. try to exert leverage with the program loan?

Obviously A.I.D. tried in the negotiations to influence policy. Quantitative and qualitative targets were linked to all loan agreements, starting in FY 62, and it is inconceivable that the GOB would have assigned the same priorities or set the same level of accomplishments in a unilateral expression of intent. This nominal linkage in itself distinguishes Brazil from the NESA countries, in which conditions were fewer and often undocumented. The more important question is whether A.I.D. tried in the disbursement process to influence policy. The tranche review system alone serves as a reminder of U.S. interests, even if tranches are released on schedule. In Brazil's case the delays and withdrawals of tranches clearly indicate that the U.S. not only talked about performance but established a credible penalty.

If the main reason for U.S. tranche delays was to avoid losing dollars to third countries during a run of Brazilian reserves, it cannot qualify as an attempt for leverage under the ground rules of this study. The theory of program loan leverage is that the bribe is sufficient to get action in unrelated or once removed areas of policy. This is a hard issue to sort out in Brazil, since the main tranche tests were stability tests, and instability anywhere in the domestic economy usually affected the foreign sector. A.I.D.'s principal target was inflation, however, and A.I.D. was tough whenever the concern for prices threatened to rise. A.I.D.'s interests were obviously broader than Brazil's level of reserves, and thus this is a legitimate case of attempted leverage.

B. Did Brazil perform?

One can identify four periods in which lack of progress toward or a short fall from stated targets resulted in delays and cut-offs in program loan disbursements: (1) after the failure of the March 1962 stabilization plan, A.I.D. held back on release of the final $25.5 million of $100 million originally committed in March 1961 for FY 62 obligations. It was finally obligated in March 1963 from contingency funds; (2) the Bell-Dantas negotiations in the Spring of 1963 produced agreement on stability conditions and the size of an FY 63 aid package, but before disbursement instructions could be written the new stabilization plan collapsed and the loan program was aborted. USAID left the door open for further negotiations, but the Goulart Administration felt that a continuation of the then chaotic conditions was more to its political interest; (3) credit and foreign exchange crises developed in the Spring of 1966, and USAID delayed release of the second FY 66 tranche for three months until the Minister of Finance agreed to various corrective action; (4) credit and exchange crises reappeared in the Spring of 1967, following heavy deficit spending by Castello-Branco in the closing months of his administration and an initial period of uncertainty and credit relaxation under the Costa e Silva regime. The FY 67 $100 million loan was in effect aborted, though a second $25 million tranche was released in February 1968 and a third $50 million tranche in May under ground rules for FY 68.

On the other hand, the record shows notable achievements as well. The GOB not only reduced the rate of inflation, but improved the administration of budget and revenue policy, and introduced significant reforms into the monetary and credit system. Moreover, there was commendable progress in import and agriculture policy.

C. Did A.I.D. get leverage?

A.I.D. did not get leverage during the Quadros and Goulart Administrations, that is clear. But A.I.D. seemed to have had a considerable impact on Castello-Branco's policies, and it appears that A.I.D. is now beginning to have an impact on the Costa e Silva government through the Minister of Finance, Delfim Neto. There are simply too many major institutional and policy changes over the past four years in areas in which the U.S. has expressed a strong interest since 1961 -- in budget procedures, the tax system the economy of the Autarquias, the money and credit system, the use of the coffee fund for diversification and deflation import controls, exchange rate policy, and agricultural price policy -- to suppose that it would have happened anyway, or even that it would have happened eventually. In other words A.I.D. not only accelerated changes, A.I.D. helped initiate some of them, such as import liberalization.

D. Can the leverage be attributed specifically to the program loan?

The program loan did not replace a non-project A.I.D. grant program, as it did in other countries, so whether the pattern of A.I.D. leverage had already been developed and the program loan instrument merely continued is not an issue. There is the possibility that the program loan partially replaced EX-IM Bank loans. The fiscal year figures suggest such a substitution. But Bank authorities in any case did not try to execute leverage on fiscal and credit policy. In other words, the USG's credible leverage position in Brazil developed with the program loan. This is not to say that the level of project loans was not used in the bargaining process. Indeed the FY 64 CAP written in December 1962 states "It is believed that the level of U.S. aid can be a most effective instrument for inducing economic stabilization actions ... [but] ... only project-type assistance is presently recommended," and the FY 68 loan negotiating instructions clearly indicate that the entire loan program will be negotiated as a package. But we were told that the actual negotiating leverage of project loans on general fiscal policy was nil, after the beginning of the program loan period. The FY 64 CAP discussion represents the period when large project loans to the North East were A.I.D.'s only negotiating instrument. In fact, some project loans requiring large public budget allocation (e.g. power loans) made some of the restrictive fiscal policies more difficult to achieve.

The local currency counterpart generated by program loans was also used to advance the objectives of the A.I.D. program. Local currency funds were being used to finance some of the government's budget deficit. In effect, they substituted for funds that would have been created via a deficit finance mechanism. By insisting on the sterilization of the local currency equivalent of program loans, A.I.D. forced Campos and Neto to rely on other sources of finance for the government budget -- sources related to the conditions specified in assistance agreements.

IV DETERMINANTS OF LEVERAGE

A. The Loan

1. Size of loan. The FY 62, abortive FY 63, and FY 67 loans all were priced at $100 million. They all failed to achieve their objectives. The FY 65 and FY 66 loans were priced at $150 million. They both got through, the first one handsomely, the next by a hair. The relationship between size and leverage is tenuous.

2. Changing aid level. When A.I.D. jumped from the FY 62, FY 63 level of $100 million to the FY 65 level of $150 million, the result was action (and a new President). When A.I.D. slipped from $150 in FY 66 to $100 million in FY 67, there was trouble (and another new President). So far the implicit hypothesis is confirmed, though the relation may be spurious. It appears, however, as if the further slip to $75 gross new funds in FY 68, will produce an improvement over FY 67 (though, in FY 68 net terms -- $170 --, the shift in direction of leverage effects is consistent with the hypothesis).

3. Dissipation through time. The loan level was constant at $150 million in FY 65 and FY 66. There was no significant difference in performance results. There are no other tests of the dissipation hypothesis, except for the further deterioration in achievements between FY 66 and FY 67, which has other good explanations.

B. The Conditioning System

1. Number of loan conditions. There is nothing to indicate that overall performance correlates one way or another with the number of conditions. The addition of a large number of sectoral development targets in 1966 and 1967 does not appear to explain the deterioration in progress from 1965 to 1966 and again from 1966 to 1967. On the other hand, according to one observer, it may have encouraged the GOB to undertake a very important reform of agrarian pricing policy. In any one year only a few conditions were emphasized and both USAID and the GOB knew that the other knew which they were. The other conditions

were not all "frosting", though some were added merely to satisfy U.S. Congressional requirements. Since the number of "key" issues presented by the U.S. negotiators did not fluctuate much, there is no information on which to test the hypothesis.

2. Specificity of loan conditions.* Specificity has two dimensions. On the one hand it means the detail with which conditions spell-out institutional and policy reforms. On the other it means the setting of fixed quantitative tests of progress. It may be possible to infer from the Brazilian experience that the post FY 64 loans were more successful than the earlier ones partly because USAID provided both the motivation and some valuable technical assistance to the Brazilian authorities in working with them to design the details of a stabilization program. The monetary budget, for example, is part of the fall-out from U.S. (and IMF) insistence on the development of a coherent, practical assault on all contributing forces to inflation. It may also be possible to say that USAID's insistence on including in the FY 66 agreement detailed measures for agricultural price and credit policy prodded the GOB into taking the remarkable steps toward restoring parity to the rural sector which some observers have noted.

With respect to quantitative tests, however, it is hard to make any judgments about the desirability of specificity. The significant achievements in Brazil have been in the qualitative dimensions: tax reform, agricultural diversification, improved budget procedures, etc. But that is not surprising, since the quantitative tests are not prescriptions but ceilings on indicators influenced by an agglomeration of policies, and real success is measured not by meeting the tests but by improving those policies. Indeed there is some reason to believe that by holding firm on the quantitative tests, as A.I.D. did to the point of cutting off further tranche releases, it could happen that a country would be penalized for problems beyond its control and not given due recognition for long-term self-help achievements which, though failing to meet the test in one year, may be sufficient in the nest. I do not think the tests were pushed this far in Brazil. But the danger exists. Conversely, without quantitative tests the GOB may not have made as good a show as it did. The use of quantitative tests is a delicate art -- they can encourage the recipient to make changes he otherwise would not have made, but if drawn too tightly they may penalize where penalty is not advised.

3. Area in which exerted. A.I.D.'s main conditions were related to stabilization. Within this general category, however, there seemed to be greater progress toward stabilizing the federal budget than either the monetary budget or the balance of payments. Some observers point also to coffee policy and wage policy as areas of substantial achievement.

*See note page 16

4. Rigor of loan condition enforcement. It is hard to show that the host government's concern for fulfilling conditions correlates positively with A.I.D.'s. There is evidence that this may have happened in 1966. Unfortunately, in 1962 and 1967, the two years when A.I.D. appeared to have been the toughest on further releases from loans which were already being disbursed, the situation never recovered and later tranches had to be withheld.

The establishment of credibility for A.I.D. loan conditions was particularly critical after the first few years of the Alliance when the effort to move large loan funds set aside by Congress had left the impression that large and relatively unconditioned loans were readily available in exchange for pledges of self-help. A severe mechanism of quarterly progress reviews prior to tranche releases was designed to generate this credibility. This device is now being relaxed, to one or two reviews and tranches per year, in the belief that credibility has been established.

C. Environmental Factors

1. National politics. There is an obvious political imprint on the course of program loan negotiations and releases. Nothing seemed to go right under the Goulart Administration. But after the Castello-Branco accession two loans were released in relatively good order. Then when Costa e Silva took over in 1967, there was a period of difficulty that led to the effective termination of the FY 67 loan. This correlation with Presidencies is over-simplified, however, since Castello-Branco was getting into trouble with the loan conditions when he left office, and Costa e Silva was getting out of trouble by the end of CY 1967. Moreover, part of Castello-Branco's success is attributable to his tough wage policy in 1964-1965. It is doubtful whether Castello-Branco could have continued to depress real urban wages throughout his presidency. He presented his successor with a political situation which inevitably demanded some relaxation in economic controls. Nevertheless, the difference between both these Presidencies and the Goulart period is striking.

2. International politics. A.I.D.'s anxiety over Goulart's domestic policy stemmed from the leftward drift within his administration as well as from incidents such as the exproporiation of ITT. Subsequently, Castello-Branco's honeymoon with the A.I.D. disburser, which lasted through the final tranche of the FY66 loan, was longer than it would have been had he not exhibited such a reasonable accommodation to U.S. foregin policy.

3. Multilateralism. The Brazil-IMF relation was discontinuous, broken during periods when foreign reserves were accumulating and an IMF standby was unnecessary. There are also reports of friction between the two sides and relations may have been less harmonious than in other countries we have reviewed. But the

IMF and A.I.D. presences undoubtedly reinforced each other with good communication between staffs and accomplishing more than a bilateral approach would have. The U.S. opened doors for IMF in Brazil, and the large and seasoned joint Embassy-A.I.D. analysis team had a better comprehension of local matters than the visiting IMF teams. Generally, however, the U.S. preferred to keep the IMF out in front in the negotiations in years when a standby was necessary.

The IBRD is now acquiring a major influence on policy. Its special interests in the transport sector advance the pursuit of stabilization since the transport deficits are considered a contributory factor to Brazilian inflation. The IDB, on the other hand, has not advanced self-help.

V. CONCLUSIONS

The Brazilian program loan experience enhances the credibility of the conditions-precedent strategy -- the U.S. Government has shown itself willing to delay and even terminate disbursements. A.I.D. tolerated slippage from specified targets. The toleration appears to have varied somewhat from one GOB administration to another. It was a function of the U.S. country team's perception of the relative importance of the different targets for securing U.S. and GOB policy goals. And it was also partly explained by the deliberate choice to set some targets within the "incentive" range rather than the " probable" range. In addition, the degree of Brazil's support of U.S. foreign policy may have influenced disbursement policy in some years. But overall, the U.S. position has been convincing,and the Brazilians know they cannot take U.S. non-project aid for granted.

What is not clear is whether the leverage has worked as well as expected. The problems attributable to declining coffee earnings and an ingrained expectation of inflation continue, and the country slips back often into credit and exchange crises from which the Federal authorities are poorly equipped to extricate themselves without upsetting the coffee growers, and Sao Paulo industrialists and other entrenched domestic interests. When it has come to a showdown between meeting program loan conditions and obliging those interests, the latter have usually won. Still, inflation has been brought under better control, the authorities have become more sophisticated in the application of stabilization policy, and they have made major improvements in budget and revenue administration and the money and credit institutional apparatus. It is a well-grounded judgment, therefore, that A.I.D. leverage has significantly influenced this process, by forcing the Government both to take corrective actions sooner and with greater efficiency than would otherwise have been the case, and to improve the statistical and institutional bases for decisions.

PPC/POL/ES:ERice/CHemmer:jew:9/15/69

Note by John H. Kaufmann, PPC/RC/LA

It was necessary for the study to use targets, goals or quid pro quo's as a means of evaluating country performance and AID program leverage when making a Washington desk evaluation study, but these conditions can and have been misleading when evaluating AID program loan leverage in particular instances.

The establishment of meaningful conditions is truly a negotiating art; but so is the evaluation of satisfactory performance. On the one hand, these conditions should be tough enough to achieve actions which would not otherwise have been taken, tough enough to make the policy makers stretch or try harder than they otherwise would, and often they should be set somewhat beyond the reach of anticipated achievement, but yet be within the realm of possibility so as not to decrease the condition's credibility during negotiation or later review. In addition to the artistry and wisdom required in establishing these conditions to make the USAID/country negotiations more effective, the U.S. designers of these conditions always had to recognize the difficulties of accounting for performance under program lending to AID/Washington and later investigating powers such as the GAO, Moss Committee, etc. This, I fear, too often tended to influence the USAID missions to either "play safe" by reducing the condition's toughness, making the written commitment more obscure or less quantifiable. A margin of leverage was thus lost by limiting the condition from an otherwise credible level because of fear that it would be viewed as a quantitative performance target which had to be arithmetically met in order to release the tranche, rather than a goal toward which satisfactory performance could be judged.

These important considerations are not adequately discussed.....the discussion in the Brazil paper (p. 12) plays with the point as an afterthought. Granted that this kind of analysis is difficult to make from afar, but this fact ought to be recognized in the study as one of its inherent limitations, particularly when the achievement or non-achievement of specific targets is necessarily given such detailed attention in the evaluation and when judgments are made such as "U.S. leverage probably worked though certainly 'success' fell considerably short of announced expectations" (p. 7).

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CHILE

by

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March 1970

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CH 66

PROGRAM LOAN STUDY: CHILE

I. INTRODUCTION

Since 1963, A.I.D. has made five program loans to Chile involving total gross obligations of $262 million. In addition, there were two sector loans -- for FY 1967 in education and for FY 1968 in agriculture -- for a total of $33 million. Stated in per capita terms, this aid level was several times higher than for any other country granted program assistance during the period. As a lending record, it reflects the vigorous U. S. effort to support and influence the development policies of the Frei Government as that regime attempted to implement the objectives and prescriptions of the Alliance for Progress.

Briefly, A.I.D.'s experience with program lending in Chile shows the following pattern. The loans of 1963 and 1964 to the Alessandri Government initiated the practice of program assistance to Chile and served as a holding action in a pre-election period. In 1965 and 1966, substantially larger loans and a considerable increase in the number and breadth of loan conditions responded to Frei's initiation of a wide range of reforms. Meanwhile a gradual increase in copper prices beginning in 1964 led the GOC to decline program assistance for 1967; internal pressures had brought excessive wage increases, accelerated inflation, and a deterioration of the balance of payments position. The small program loan of 1968 was not expected to reverse this undesirable trend. Meanwhile, sector loans (in education and agriculture) were introduced in 1967 and 1968 in an effort to effect policy changes that had not yielded to pressure through program loan conditions.

Overall, the objective of program loans to Chile has been to generate a self-sustained growth process and to eliminate Chile's chronic balance of payments crises. To this end, the required self-help measures have focused on the control of inflation, realistic exchange rate adjustment, and reforms of GOC taxation and expenditure policy. In addition, sectoral loans have attempted to support structural reforms in agriculture and education. Moreover, through the continuing dialogue over self-help performance, A.I.D. has constantly encouraged the development of a regular, systematic, and critical self-examination process within the structure of the GOC itself.

The manner of negotiating and administering program loans has conformed to a fairly standard pattern since 1963-1964. Negotiations produce a set of specific commitments which are then expressed, outside of the loan documents, in a letter of intent to the CIAP and in standby agreements with the IMF. As far as possible, the specified goals are accompanied by quantitative or temporal measures by which performance can be tested. Finally, the loan funds are released in quarterly or semi-annual tranches following a comprehensive A.I.D.-GOC review of performance up to that point.

II. CHRONOLOGICAL SUMMARY OF CHILEAN EXPERIENCE

A. Pre-1963 and Subsequent Non-Program Aid

Prior to FY 1963, A.I.D. assistance to Chile was relatively insignificant and consisted mainly of project aid and technical assistance. Together with PL 480 loans and grants, these kinds of aid averaged a little over $20 million annually in the period just prior to the Alliance for Progress. In addition, the Export-Import Bank and the IBRD were occasionally large lenders to Chile.

After FY 1962, project lending by A.I.D. declined sharply, disappearing altogether in 1968. PL 480 authorizations continued at an $18 million annual rate. Program lending, therefore, has dominated the bilateral negotiations since 1962. Export-Import Bank loans have been extended on a substantial level in coordination with the program loans. Treasury Exchange Agreements have also been employed to support the program assistance strategy.

A donor consultative group led by the IBRD was proposed as early as 1962, but the projected consortium was never formed. Nonetheless, the IBRD and the IDB have provided substantial assistance to Chile, even exceeding U. S. aid in FY 1967 and 1968. In each program loan year, the GOC has arranged an IMF Stand-by Agreement containing self-help conditions to which A.I.D. has tied release of the program loan.

The first major U. S. loans to Chile occurred in FY 1962. A large $100 million loan was extended for earthquake relief aid. However, the determined U. S. effort to get Chilean development underway began with the Goodwin-Moscoso mission to Santiago in March 1962. The discussions focussed on sources of finance for Chile's ten-year development plan which had been endorsed by the OAS Wisemen. The initial U. S. commitment was estimated at up to $350 million over the first five years of the plan. An immediate assistance package of $80 million was worked out with the first $40 million designated as a two-stage project loan to CORFO (the GOC development bank). This loan was apparently the immediate predecessor of the later series of program loans. Mission correspondence with AID/W later identifies it as the first program loan since it was designed to support Chile's balance of payments on the dollar side and the GOC capital investment budget on the escudo side. A.I.D. expected to influence GOC exchange reform policy as a result of this assistance; when the GOC did not carry out an expected devaluation in September 1962, no further discussion of the second $40 million loan took place.

B. FY 1963: $35 Million

The unsatisfactory leverage derived from the loan to CORFO induced A.I.D. to work directly with the Central Bank in negotiating the conditions for the second Alliance for Progress development loan. USG representatives had some misgivings about the seriousness of Chile's commitment to Punta del Este goals and the approach of 1964 presidential elections suggested that little headway could be made on Chile's pressing problems until after the question of governmental leadership had been resolved. Nonetheless, an aid package was put together consisting of a $35 million program loan, $15 million in Export-Import Bank credit, and a $10 million Treasury Exchange Agreement providing drawing rights, pari passu, with the IMF.

The program loan was authorized in early January and negotiations on the complete package were finished by the end of the month. In the Negotiating Instructions, the central concern and basic strategy of this and successive program loans found succinct expression.

> The IBRD, the Wisemen, and we have agreed that a stabilization program forms an essential element of Chile's development effort. The USG has for the past several months been encouraging the GOC to reach agreement with the IMF on such a program supported by IMF assistance. Without the exchange adjustment, increased public savings and monetary and fiscal restraint which such an agreement implies, a deterioration in the Chilean economic situation can be anticipated, together with a lower level of other external resources and inevitable requests for emergency aid from the U. S.

Accordingly, the release of the first tranche of $17.5 million was conditioned on Chile's entering into an IMF standby agreement. The program loan agreement viewed fulfillment of the conditions for standby eligibility as evidence of satisfactory performance on exchange reform and monetary policy. The IMF standby was established in January and the first tranche was released.

Self-help conditions for release of the second and third tranches included the following: (1) continued IMF standby eligibility -- as evidence of continued progress towards needed exchange adjustment and monetary policy reform; (2) tax and other fiscal reforms designed to generate a budget surplus on current operations sufficient for the non-inflationary finance of public sector investment; (3) establishment of an escudo counterpart fund and agreement with A.I.D. on its use for appropriate development projects.

The second and third tranches were initially scheduled for release in May and August 1963. Agreement on the use of counterpart funds was quickly reached in March and A.I.D. secured priority for social overhead development projects such as hospitals, housing, and schools. However, the evaluation of other prescribed self-help performance encountered difficulties that delayed both releases some two months. The exchange rate was depreciated in all markets, spot and future, but the 15% devaluation for the year was far below that warranted by domestic price increases. However, the Mission accepted this performance as satisfactory due to the earlier depreciation in 1962. Similarly, the budget surplus targets were exceeded by some E^{o} 30 million, but since the surplus defined did not include the state enterprises and autonomous agencies, the public saving generated outside the fiscal budget actually fell in real terms. In view of these oversights in the required self-help conditions, it was not surprising that prices rose some 45% and little discernible progress was made towards the stabilization target.

C. FY 1964: $55 million

The political climate throughout 1964 was very unfavorable for strict conditioning procedures. From the very beginning of negotiations, the Mission and the GOC argued that the fall elections constituted special circumstances that would greatly affect the feasibility of self-help performance. The Mission stressed that the premise of 1964 aid strategy was that

> ...1964 would be a difficult election year. Chile's economic situation was far from satisfactory and proper corrective action could not be taken by Chilean authorities in 1964. But the manifold U. S. interests in Chile would probably be best served by continuing substantial development assistance, the purpose of such assistance being the effort to hold development gains already made and provide a better starting point for the new development undertakings by a new Chilean Administration.

Specifically, there was no solid assurance that the GOC could or would achieve the needed budget surpluses or that the rate of inflation could be held to less than thirty percent. Chile also faced an extensive debt renegotiation problem during 1964 for which IMF assistance would have to be negotiated.

The first GOC estimate of its CY 1964 assistance needs, in November, 1963, amounted to $85 million. The Mission quickly scaled this down to a basic package consisting of a $40 million program loan and $16 million in Pl 480 assistance. Although AID/W had settled on the amount of program aid by mid-December, 1963, the signing of the 1964 package was delayed for four months while negotiations over self-help conditions continued. In part, the signing was put off in an effort to secure a more credible GOC commitment to a schedule of current account surplus targets that would reduce the likelihood of excessive inflation and offset unanticipated increases in public sector wages. A.I.D. was also insisting on a role in approving the use of local currency generated by program assistance and by PL 480 aid.

The signing of the 1964 loan was also delayed by protracted debate of a Chilean request for program aid beyond the agreed $40 million level. The GOC request for supplementary assistance began with a request for $45 million more but finally took the form of a bid for an additional $10 million in exchange for a doubling of property taxes and reform of tax incentive legislation. The Chilean negotiators held out for some form of explicit commitment to this additional aid within the $40 million loan agreement, but AID/W preferred to keep the issue of supplementary assistance as a separate matter for future discussion.

The $40 million program loan was finally signed in April, 1964. The required IMF standby had been secured in February and, as in the previous year, disbursement of the program loan was tied to continued eligibility under the IMF agreement. In addition, the ambiguities that plagued enforcement of the budget surplus targets in 1963 were hopefully remedied by tying disbursements to specific budget surplus goals for the public sector and for the decentralized agencies, taken separately. Disbursement was arranged in four tranches, with cumulative budget surplus targets for each quarter. The loan agreement also conditioned disbursement on the presentation, in each quarter, of satisfactory plans for the use of the equivalent escudo counterpart of the cumulative sum to be released. All tranches were released, usually several months after the date projected in the loan agreement. The price level rose 38% during 1964, considerably above the target rate of increase for the year, and the GOC self-help performance did not outstrip A.I.D.'s modest hopes.

The amount of supplementary program assistance for 1964 was finally settled in May. Although the Mission and the GOC had developed an understanding in the initial negotiations that additional help would be related to self-help measures beyond those specified in the loan agreement -- namely, the tax reforms described above --, A.I.D./W was unmoved by determined GOC action to effect the tax reforms. It urged, in agreement with the OAS Wisemen, that the GOC was not sufficiently committed to achieve the targeted budget surpluses and that aid in excess of $40 million should require other self-help measures (i.e. other than the tax reforms) related to the budget surplus targets.

Decision on the matter had apparently been deferred indefinitely when the issue of additional aid was quickly settled by an unforseen exchange crisis. In April, the IMF warned that the GOC might not be eligible for a drawing in May due to a rapid deterioration of its net foreign exchange position. Since IMF eligibility was a central condition for the entire program of assistance (and, incidentally, for Chile's critical debt renegotiations in 1964) and since a faster rate of A.I.D. disbursement could enable the IMF to find no net use of foreign reserves -- the test of standby compliance --, the $40 million program loan was amended in May to provide for a $15 million cash transfer which neatly resolved the potential problem. This decision to provide essentially unconditioned supplementary aid, despite the prior protracted debate over satisfactory conditions for the same, was consistent with the 1964 loan strategy (outlined at the beginning of this section). The overriding U. S. concern was to prevent an economic crisis that would strengthen the election prospects of extremist candidates -- in particular, the leader of the extreme left, Salvador Allende.

D. FY 1965 - $80 Million

With the election of the Frei Government in 1964, A.I.D.'s expectations that the program loans could yield significant leverage on self-help performance rose sharply. In an unprecedented pre-negotiation session, Frei's entire cabinet came to Washington in late 1964 to discuss the development program for which they wanted A.I.D. support. AID/W persuaded the new GOC to emphasize short-term objectives -- in particular, monetary and fiscal policy -- rather than longer range goals such as large scale public housing and measures to effect a major redistribution of income.

As a result of the new government's interest in implementing a wide range of policy reforms, the Mission increased the number and breadth of conditions attached to the loan as well as the amount of the loan. The Mission explicitly stated that the

> ... present program loan proposes a broader over-all approach . . . /which/ is established in the government's Letter of Intent to CIAP. The quarterly reviews will cover specific achievements and will also entail a broad review of developments in all fields and sectors.

The Letter of Intent contained a minimum of fourteen measures which the GOC indicated it intended to pursue. Many of these were of a general nature and included e.g. educational, banking and social security reforms; review of present wage policies and establishment of new wage policies during 1966; re-examination of the rate structure of decentralized agencies with a view towards raising the level of savings; re-examination of the entire GOC administrative structure for the purpose of reducing general operating costs and reform of pricing and marketing policy.

Among the precise targets were the following:

(1) Achievement of a specific level of current account budget surplus for the fiscal sector and the decentralized agencies. The amount of surplus was established on a quarterly cumulative basis;

(2) An annual increase in the money supply of 25 percent "geared to achieve" the target of a price increase not greater than 25 percent during 1965;

(3) Retention of a flexible exchange policy as measured by the usual quarterly international reserve test. The Mission stated that this was a "key" condition.

(4) Total 1965 public investment targeted to reach E° 2,038.8 million financed from internal and external sources. If public sector savings or external financing falls below anticipated levels, the GOC would reduce the public investment program by the amount of the shortfall.

The program loan would be disbursed in four equal tranches. The first tranche would be released in December 1964 as soon as conditions precedent were met. The next three tranches would be released as soon after April 1, July 1, and October 1, as possible. This would depend on formal presentation of quarterly progress by the GOC and completion of the formal A.I.D. review.

In the September 1965 Country Assistance Program book the Mission stated that "While the U. S. has expressed some concern with the monetary, fiscal and exchange rate policy, the GOC has passed the basic quantitative tests.... With regard to longer term measures, accomplishments have not been outstanding. Yet, there are indications that some progress is being made in reform measures."

Although prices increased by only 26 percent in 1965, monetary expansion rose well in excess of targets, approximately 65 percent. This unexpected expansion resulted from an uncontrolled accumulation of overdrafts that the budget plans had overlooked. The rate of exchange did depreciate by 14.5 percent from December 1964 to December 1965 but as prices rose 26 percent the escudo remained over-valued. The Mission voiced considerable dissatisfaction with this GOC performance. Despite the shortfall in the exchange rate, however, Chile's net international reserve position did improve.

The total public sector current account surplus was E°1194 million, four percent below the target of E°1243 million. This resulted from a shortfall in the public sector surplus which was partially offset by a larger surplus in the decentralized agencies than had been anticipated.

Public sector investment totalled E°1,771.5 million compared to the target level of E°2038.8 million. This shortfall exceeded the slight decline in public sector savings and therefore was in line with obligations under the CIAP letter. Nevertheless, the GOC did borrow heavily from the Central Bank in order to finance its expenditures.

Adherence to the other conditions stipulated in the CIAP letter was mixed, and in view of the fact that many conditions were stated broadly and were not open to precise measurement, decisions on accomplishments were open to individual value judgements. The Mission reported that "Performance in 1965 was hindered by determined opposition from both the right and the left but considerable progress was recorded." All funds were released.

E. FY 1966 - $80 Million

This loan was conditioned as usual on adherence to the specific measures listed in the CIAP Letter of Intent as well as conclusion by the GOC of a Stand-by agreement with the IMF. The Mission stated that the loan

> will not require that all of the conditions be fully met . . . the GOC will be required to explain any failure to meet specific targets to the satisfaction of A.I.D. and to show intention of taking steps to correct significant problems. A.I.D. will then determine whether or not the overall situation, including intended corrective measures, is such that the release should be made.

The CIAP letter contained a summary of almost every policy measure which the GOC intended to pursue during 1966. The IMF Stand-by refined some of the conditions so as to make them more readily measurable. Although the loan was conditioned on a whole series of policy measures the Mission emphasized that achievement of the public finance targets was essential for stabilization and growth of the Chilean economy.

Among the conditions stipulated in the CIAP letter and the IMF Stand-by were the following:

(1) Public sector savings targeted to reach E^o1,536 million in 1966, with specific quarterly targets set for both the fiscal sector and decentralized agencies;

(2) Net reserve position of the banking system targeted to increase about $30 million but "the exact timing and amount of surplus will depend upon many unpredictable factors." The Mission stated that it would reach a *confidential* [italics added] understanding with the GOC that it will allow the exchange rate to depreciate in 1966 to the full extent of any price increase during the year plus the percentage of increase in overvaluation during 1965;

(3) Gross public sector investment targeted to reach a level of E^o2,625.8 million, a 26 percent increase over the 1965 level;

(4) The maximum level of fiscal current account transfers to state enterprises would be E^o240.6 million;

(5) The 1966 floor price for agriculture products, especially for milk and wheat, would be announced "well before" the 1966 planting season in May;

(6) GOC borrowing from the Central Bank would be limited to E°70 million;

(7) Efforts would be directed to limiting the price rise in 1966 to 15 percent; and monetary expansion would be limited to 25 percent;

(8) Legislation would be introduced in January 1966 to limit wage increases for certain groups to 100 percent of the cost-of-living increase and 60 percent for other groups.

As in previous agreements funds would be released in tranches on the basis of a quarterly review of accomplishments. The first review would cover the last quarter of CY 1965, at which time about $29 million would be released. After performance reviews in the first, second and third quarters of CY 1966, $17 million each would be released.

All funds were released although some of the many conditions specified were in fact not met. The major shortfall was with respect to wage policy where the GOC lacked the power to effect its policy objectives.

The cost-of-living index rose 17 percent, as then estimated, almost precisely on target but the money supply increased by 39 percent. The foreign exchange rate depreciated more than the increase in prices as targeted i.e. 23 percent compared to 17 percent. This approximately compensated for the earlier 1965 shortfall. The public sector current surplus exceeded the target set by about 27 percent. In contrast, public investment in industry, agriculture, and mining sectors fell short of targets and in fact investment in the latter two sectors failed to reach 1965 levels, as measured by their share of total investment.

The net reserve position in 1966 improved upon the target set; this was due in large part to the rise in copper prices during the year. Conditions set as regards wages and agricultural prices were not met.

Although all funds were disbursed, there was some delay in tranche releases. The second tranche was authorized on June 18 only after the Mission had reached agreement with the GOC on specific issues dealing with the copper windfall and despite a further delay in the promised announcement of agricultural support prices. The third tranche was withheld because of delays on the part of the GOC in providing information for the second quarterly review. This tranche was then combined with the last tranche after the final September review.

F. FY 1967 - No Program Loan; $10 Million Sector Loan

In December 1966, AID/W approved an assistance package which included a program loan for $35 million and sector loans for agriculture and education. During the month, President Frei announced that he would forego program assistance for 1967 as well as an IMF Stand-by. There were economic as well as political reasons for this decision. Copper prices exceeded 50 cents per pound, a level in excess of what Chile considered the "normal" price. There was Congressional pressure in Chile to increase government expenditures and raise wages above the government's recommended level. Thus, at a time when copper prices assured increased external resources, the GOC attempted to disarm its opposition by materially reducing its dependence on foreign assistance, while making strenuous efforts to win Congressional acceptance of domestic fiscal discipline. The Government did announce that if copper prices were to fall and the need developed for additional resources, it would request a program loan from the United States.

Performance in 1967 showed some commendable successes as well as an array of failures. The Gross National Product increased by about four percent and the cost-of-living index rose 22 percent. The exchange rate did depreciate in line with the cost-of-living increase and monetary expansion was considerably less than in past years. The proportion of public sector investment in agriculture, industry, education and mining rose somewhat. In contrast to these relatively favorable developments, Chile's international payments position deteriorated in 1967 partly because of a dip in copper prices, but mainly as a result of increased import demand generated by excessive domestic credit expansion. The GOC borrowed more from the Central Bank than A.I.D. earlier had recommended and prices rose about 22 percent, well above the 12 percent target for the year. In toto, then, Chile's performance in 1967 was mixed and would have violated the usual program loan conditions to the same degree as in previous years.

The first sector loan -- $10 million to education -- was granted out of FY 1967 funds. Sector loans were discussed within A.I.D. during 1966 as a way of obtaining additional leverage by unburdening the program loans of prescriptions for specific sectoral performance. The Mission preferred this approach to the Korean technique of specifying parts of the program loan to be attributable to performance on one or another indicator. The GOC decision to forego program assistance in 1967 provided an opportunity to work out the $10 million package for the educational sector which was signed in September 1967.

G. FY 1968 - $15 Million Program Loan; $23 Million Sector Loan

Copper prices were falling in the spring of 1967 and, in May, program loan negotiations began. There was frank recognition that CY 1967 assistance would serve as emergency aid to support the stabilization program. Major leverage for CY 1968 would develop from a later and larger aid package. Despite the urgency of the request for help, a series of issues delayed the signing until October, 1967. For domestic political reasons, the GOC decided not to seek an IMF Standby. A.I.D. acceded to this exception from the normal pattern with the understanding that an IMF Standby would be arranged in 1968. (The Standby was signed in March 1968.) Further delay occurred in July 1967, over discussion of the need to include PL 480 assistance in the aid package.

A.I.D. argued that the loan was designed for a rapid anti-inflationary effect. Since there was a strong demand for the goods to be financed, it was hoped that purchasers would make downpayments that would withdraw purchasing power from circulation before the goods would arrive and before new expenditures would swell the GOC budget. In line with its special character, the 1968 loan was not conditioned in the usual sense. Instead, the agreement recorded seven GOC commitments addressed to 1967 activities -- although nine months of the year had already passed. In short, the FY 1968 loan was not conditioned on future performance, but, like program assistance to the NESA countries, was extended, in the formal sense at least, in response to satisfactory past performance. A less sanguine view of GOC performance in 1967-68 would conclude that the 1968 loan was supporting assistance under the guise of a program loan.

An agricultural sector loan for $23 million was also signed in October, 1967. This loan was originally offered in December, 1966, with the announced purpose of inducing lower prices for key agricultural inputs -- i.e., fertilizer, pesticides, and machinery. In mid-1967, Frei's ambitious agrarian reform bill was passed and a broad attack on the major sectoral problems (in particular, the fragmentation of governmental jurisdiction, traditional GOC policy to hold urban food prices low, excessive concentration of land holdings, and monopolies in supply, marketing and credit facilities) could be undertaken. A.I.D.'s sectoral assistance was intended to support GOC efforts by tying tranche releases to policy decisions to raise crop support prices.

This particular measure of self-help proved difficult to execute. The GOC was sensitive to the political repercussions of higher urban food prices and the announcement of higher crop floor prices was postponed. In April 1968, A.I.D. threatened to deobligate the loan if a satisfactory price policy was not announced in the near future. By the end of FY 1968, little progress had been made and A.I.D.'s internal discussions suggested that agricultural sector aid would not be expanded until a major review of strategy had been carried out.

H. FY 1969: $20 Million Program Loan; $10.3 Million Sector Loan

The difficulties affecting program loan negotiations in 1968 we broadly similar to those that dominated the 1964 discussions. The prem of negotiating strategy, in fact, could have been expressed in much the same terms:

> ...a difficult election year...economic situation far from satisfactory...purpose of assistance to hold development gains already made...
>
> --see page 4 above.

The difficulties in 1968 were numerous. The GOC had lost ground on its stabilization program in 1967 and the rate of inflation was once again increasing. With the approach of the 1969 Congressional and the 1970 Presidential elections, policy choices would be increasingly dominated by inter- and intra-party jockeying for political support. The public sector wage readjustment bill, a test of the GOC capacity to get Congressional cooperation on stabilization policy, passed in May, 1968, in a form that increased the government deficit and added to inflationary pressures. A natural disaster further compounded these difficulties. A serious drought began to cause major production losses and extensive unemployment in agriculture, as well as a significant slowdown in industries dependent on hydroelectric power. Simultaneously the GOC began to experience falling tax revenues and a demand for additional expenditures to create employment and aid recovery.

In short, the prospects were dim in mid-1968 for any advance on the long-term goals of price stabilization followed by self-sustained growth and a phasing out of program aid. The IMF Standby promised earlier was arranged in March, 1968 and a $45 million package for CY 1968 was proposed within A.I.D. The first $20 million would come from FY 1968 funds and the other $25 million was to come from FY 1969 appropriations. The purpose of the assistance was

> to help meet the critical foreign exchange requirements of an ambitious development program and to assist in financing the public sector investment program in a manner that does not aggravate inflationary pressures.

In short, the proposal was for a holding operation. AID/W candidly noted that the objectives of self-sustained growth and a phaseout of aid within a few years were no longer sustained by the rationale of the assistance program.

In September, 1968, a $20 million program loan was signed, arranged for disbursement in two tranches. The conditioning was again minimal. The Mission stressed the importance of supporting the Frei administration and argued for release of the final tranche in December, during the final Congressional preparation of the 1969 budget and public sector wage re-adjustment measure. Preliminary plans for the CY 1969 assistance program also stress the need to support the government's efforts to prevent economic distress during the election period. Estimates of Chile's 1969 needs suggest an additional $20 million from the FY 1969 A.I.D. budget and possibly another $20 million from FY 1970 funds later in the year. An agricultural sector loan may also be extended.

Together with the program loan, a $16.3 million educational sector loan was also signed in September, 1968. This was the second educational sector loan and continued the emphasis of the first measure in supporting the Education Reform Program begun in 1967.

III. THE PRINCIPAL ISSUES

A. Did A.I.D. Try to Exert Leverage Through the Program Loans?

The historical record shows a consistent effort by A.I.D. to influence GOC policy in many respects. In most cases, the self-help conditions tied to tranche releases defined difficult performance targets and the seriousness with which A.I.D. regarded these conditions was often reflected in delays of tranche releases until the GOC provided satisfactory evidence of performance. (A fuller discussion of the enforcement issue is developed below in Section IV. B. 5.)

The degree of influence sought by A.I.D. is another question. Advocates of the "tough" approach would probably disapprove of the reticence with which difficult issues of self-help have been handled. In 1963 and 1964 and, later, in 1967 and 1968 the limited political power of the GOC administrations to effect reforms has led to an essentially "holding operation" rationale for program aid. In 1965 and 1966 when the loans bristled with self-help conditions, the apparent "toughness" largely reflected the new Frei regime's toughness with itself in its effort to launch a wide-ranging program of reform. Overall, the reasons advanced to justify the program loans show that A.I.D. has continually tried to move the GOC to adopt policy reforms. However, the Mission has always believed that, despite adverse prospects for a particular year, A.I.D. should continue to extend assistance and maintain a position of potential influence that will translate into leverage when circumstances change and the GOC again adopts a reform program with favorable prospects.

B. Did the GOC Meet the Specified Performance Standards?

A.I.D.'s judgement has consistently been that Chile deserves at least an overall passing grade on the set of performance tests attached to the program loans. All tranches were released; no funds were deobligated. On the other hand, the overall performance was of passing, not excelling, quality. The release of many tranches followed delays of several months until satisfactory proof of performance was available and, in one instance, A.I.D. threatened to deobligate funds if agreed-upon policy measures were not carried out (see Section II. G. above). In nearly all cases, the shortfalls from performance targets have ultimately proved acceptable to A.I.D. inasmuch as the Chilean Government has convincingly argued that special circumstances restricted its capacity to meet the performance goals.

The record for specific areas of GOC performance shows uneven results. Government budgeting procedures have markedly improved and net borrowing from the central bank to finance expenditures is now generally avoided. Public investment, particularly in agriculture and also in education, has risen relative to total public expenditure. The foreign exchange rate is regularly devalued with increases in the domestic price level. And minimum prices for wheat have been substantially raised.

Nevertheless, the performance efforts have only briefly succeeded in slowing Chile's endemic inflation. The increase in the price level slowed substantially through the end of 1966, then began to increase more rapidly once again. Whatever the explanation, the time when Chile can do without program assistance remains a future date quite beyond the range of plausible forecasts. The Frei regime has been unable to effect many needed reforms in the agricultural sector and it must continue a running battle with the Congress to restrain the upward adjustment of public sector wages. No really effective remedy for inflation has been pursued for more than a few years, and uncertainty regarding the outcome of approaching national elections creates doubt that policy reforms now adopted are likely to be carried forward by the new government.

C. Can Satisfactory GOC Performance be Attributed to A.I.D. Efforts and, in Particular, to the Program and/or Sector Loans?

There can be little doubt that A.I.D.'s program and sector assistance were productive of much of the satisfactory GOC performance described above. Obviously, the election of the Frei Government provided far more vigorous local support for a wide range of difficult policy reforms. Nevertheless, A.I.D. and the GOC frequently found themselves at odds over the selection and pace of reforms to be adopted. In some instances (by definition difficult to identify), A.I.D. adopted loan conditions that embodied measures which the

Chilean Government had independently decided upon. The record suggests, however, that a great part of the satisfactory GOC performance came about only through the consistent and firm A.I.D. position that certain policy measures were essential conditions for continued program assistance. In particular, A.I.D.'s insistence broke the lengthy GOC debate over advance announcement of agricultural price policies. The IMF and CIAP participated in the effort to induce GOC policy reform but their roles were clearly subordinate to and largely defined by A.I.D.'s concept of the job to be done (see Section IV. C. 3 below).

IV DETERMINANTS OF LEVERAGE

A. The Loan

1. Size of Loan

The level of program lending in Chile has varied considerably during the seven FY's under study here. In absolute terms (and for program and sector loans taken toghether), the loan size in 1965 and 1966 was nearly eight times that of the low year, 1967,and twenty-five to fifty percent larger than lending in the other four years. A.I.D. clearly experienced its peak influence in the high loan years; moreover, GOC policy that strayed farthest from A.I.D norms occurred in the lowest loan year. But the experience illustrates what one might expect -- that negligible lending produces negligible influence -- while failing to demonstrate the contrary proposition -- that high lending levels produce extensive influence. The highest loan levels, in 1965 and 9166, coincided with the first two years of the Frei Government. The significant degree of influence A.I.D. enjoyed in that period must be attributed to the readiness of the new government to undertake sweeping reforms rather than to the lending level itself, unless a similar degree of influence is once again achieved if the lending level of FY 1969 approaches that of the earlier years.

2. Changes in Size of Loan

Five marked changes in lending levels have occurred since FY 1963. Loan size increased by over fifty percent in 1964, and by more than forty percent in 1965; it dropped precipitately in 1967, then more than doubled in 1968 and, if the Mission proposals are carried out, will nearly double again in 1969. In general, the increases represent A.I.D. efforts to gain leverage; the single decrease in loan size resulted from a GOC decision to decline program aid for that year.

The first large increase in loan size, in 1964, did not yield increased leverage. The following increase, in 1965, initiated the Frei era and was associated with a marked expansion of A.I.D. influence on GOC policy. Although the aid level was unchanged in 1966, the level of influence was equal to or greater than that of the previous year. In 1968 and 1969, a rising aid level yielded growing influence on GOC policies. Overall, experience to date indicates that increases in aid levels may (but do not necessarily) produce increased leverage; Chilean experience does not shed light on the effects of deliberately decreased loan levels.

3. Number of Successive Loans

Experience with Chile neither proves nor disproves the hypothesis that leverage tends to dissipate over time. No real opportunity to test the view occurred until the election of the Frei Government in late 1964. A case can be made for the proposition that leverage increased over the following four years. During 1965 and 1966, leverage increased, judging from the wide range of self-help measures that were included as loan conditions and undertaken by the new government. Chile's decision to do without an aid package in 1967 was an attempt to escape the conditioning process -- a kind of backhanded admission that the GOC still associated program assistance with an uncomfortable degree of A.I.D. leverage on Chilean policy. Finally, with the renewal of program loans in 1968, A.I.D. continued its insistence and Chile continued to accept the view that aid would be tied to self-help policy commitments.

However, one can also argue that, while in 1965 and 1966, A.I.D. enjoyed considerable leverage from program aid, the substantial loss of ground on major development objectives in 1967 and 1968 is not adequately explained merely by the fact of more adverse economic circumstances. More importantly, it evidences the growing cost of leverage from continued program aid. To sum up, neither of these lines of reasoning decisively resolves the issue of whether or not a dissipation of leverage occurred over time.

B. The Conditioning System

1. Area in Which Conditions were Specified

A.I.D.'s experience with Chile provides some lessons in the art of gaining leverage in diverse areas of policy when the host government is staffed by semi-autonomous cabinet ministers. Initially, A.I.D. tried to establish credible conditions for performance in various sectors of the economy as a part of the program loan agreement. Experience through 1966 showed, however, that the Minister of Finance who signed program loans did not have the authority to ensure that conditions dealing with policy in non-monetary sectors of the economy would be carried out. While delays in tranche releases could prod the Minister of Finance to carry out commitments relating to budget policy or exchange devaluation, the withholding of funds for shortfalls in other sectors would tend to produce budget cuts across the board, thereby penalizing sectors other than the offending one.

While continuing to emphasize the need for reforms throughout the economy, therefore, the USAID began to utilize sector loans to education and agriculture in 1967 and 1968 in an attempt to influence policy more effectively in these sectors. Through this means, the Ministers of Agriculture and Education would be obligated to implement the agreed policy actions, and decisions to hold back tranche releases would have the specific impact desired.

In summary, the introduction of sector loans probably yielded increased leverage for A.I.D. although the results in the agricultural sector have been disappointing. Several more years of experience with packages of program and sector aid are needed before any well-grounded conclusions can be drawn.

2. <u>Specificity of Loan Conditions</u>

The conditioning of loans to Chile was, for the most part, expressed in quite specific terms. Budget surpluses were defined as minimum escudo sums to be achieved by specific dates. Acceptable rates of increase in the price level were set down as so many percentage points of increase between particular dates. The only area of vagueness in the agreements was the relationship of the exact targets to the concept of acceptable performance that A.I.D. would employ in deciding upon tranche releases. The record seems to show, however, that the exactly-stated conditions were credible despite the implicit understanding that they were not strictly binding targets. The GOC apparently refused to commit itself to conditions that seemed genuinely unrealistic; hence, the Chilean Government generally made an honest effort to achieve the specific conditions of the loan agreements, and the USAID was generally ready to accept the explanations for shortfalls that the GOC advanced.

3. <u>Number of Conditions</u>

The loan agreements with Chile carried a relatively large number of performance conditions. Some A.I.D. officials who were involved report that a significant number of the conditions were included at the insistence of GOC negotiators who wanted to use the agreement to reinforce internal governmental decisions. Other conditions were specified as part of an

A.I.D. effort to keep particular policy problems in view, even though there was no serious hope of getting GOC action on all of the matters mentioned. In general, the number of loan conditions that required GOC action of a sort that might not have been forthcoming apart from the loan was not so great as to dissipate the Chilean Government's capacity to carry out the needed reforms.

4. Frequency of Reviews and Tranche Releases

Quarterly reviews prior to tranche releases have worked fairly well in Chile. The relative frequency of these sessions forced the GOC to press steadily for the prescribed reforms and to develop the kinds of statistical reporting needed in the reviews. One significant modification that increased the leverage from these sessions was that of scheduling separate meetings with the cabinet Ministers apart from their subordinates to facilitate a franker exchange of criticisms and suggestions.

5. Enforcement of Conditions

Despite the many precise conditions for disbursement set by each loan, decisions to release the funds were ultimately based on A.I.D. judgments as to whether performance was satisfactory in the light of prevailing problems.

In September, 1965, the Mission recommended that the third tranche of the 1965 loan be released, although review of the entire period was not complete and not all conditions were met.

> While the U.S. has expressed some concern with the monetary, fiscal and exchange rate policy, the GOC has passed the basic quantitative tests . . . with regard to longer term measures, accomplishments have not been outstanding. Yet there are indications that some progress is being made in reform measures.

In fact the money supply far exceeded the targets in 1965 and the rate of exchange did not depreciate at a rate commensurate with the price increases; several other conditions were met however.

The FY 1966 loan was released despite the shortfall in some quantitative and qualitative targets. The GOC's wage policy in 1966 did not adhere to the loan commitments. In February 1966, the Mission "defended" the GOC's decision to increase wages above target ceilings for, while such increases

> vitiate to a certain extent our development objectives, it may be a small price to pay for the maintenance of good morale among the military and good relationships between the administration and the military which is among the most important of our overall objectives.

The GOC also did not announce agricultural floor prices for wheat before May 1966 as agreed. The Mission recommended release of the tranche on the grounds that the GOC, in response to Mission urging, agreed to announce the same by the end of June. Floor prices for some agricultural commodities were announced in July, but not for wheat. Nevertheless, all funds were released.

Some of the basic quantitative targets were not met in each year e.g. money supply and sectoral public investment. Others were met and still others were only partially met. Progress in some areas was substantial e.g. tax revenue rose considerably, a meaningful agrarian reform program was instituted and educational opportunities were expanded.

Given this mixed picture of GOC accomplishments and A.I.D. enforcement of loan conditions, the role of enforcement within the conditioning process was evidently quite limited. According to an A.I.D. working paper, it was stated the A.I.D. would not require that all conditions be met but rather that "the overall performance be consistent with the total objectives of the program and therefore worthy of further drawings." As all funds were released, it is obvious that the A.I.D. posture was one of general satisfaction. It was A.I.D.'s judgement that there was relative progress in Chile compared to earlier periods of development and reforms were instituted in some sectors of the economy.

There is no evidence, however, to indicate that the Mission explicitly established priority conditions or trade-offs between conditions. Monetary and fiscal policy were major issues but there was only partial success in meeting these conditions as stated in the loan agreements. The determination of satisfactory performance was an A.I.D. judgment in which any trade-offs were implicitly made. Would performance have been better if A.I.D. had strictly adhered to the loan conditions? Was the credibility of precise conditions lessened each time a tranche was released even though individual conditions had not been met? Or were the actual achievements the best that could be hoped for under the circumstances? Did A.I.D. in fact get the best performance possible because of (and not despite) the flexibility of its interpretation of adequate performance?

Answers to these questions may not be possible. First, there is no precise way of knowing whether enforcement of the letter of loan conditions would have led to better achievements. Second, it is obvious that Chile's domestic situation made it impossible for a GOC with the best of intentions to control every variable that could obstruct or negate performance efforts. Third, as U.S. aid is only a small fraction of Chile's total resources, some would argue that the U.S. could not have exerted more leverage than it did.

Although all program loan funds were released, some of the tranche disbursements were delayed. The second tranche release covering the first quarter of 1966, was authorized on June 18 (at least two months late) pending U.S.-GOC agreement in May on several issues, among which were the following: (1) the GOC would limit its expenditures of the copper windfall to $15 million ($E^o$ 60-70 million); the additional E^o 110-120 million which the GOC had intended to add to its budgeted expenditure from high copper earnings would be covered by other means; (2) agricultural support prices would be announced by the end of June (the GOC had not adhered to the May deadline previously agreed upon) and (3) a budget reform law would be submitted to Congress by the end of June. As noted earlier, the GOC only partially met the support price target. The third tranche review was delayed as the GOC failed to provide all the necessary information to the Mission in time to meet the initial release schedule. The fourth tranche review was combined with the third and all funds were released in late 1966.

The third tranche of the FY 1965 loan was withheld until the GOC agreed to undertake additional budgetary measures and readjust the priorities of its development plan; the tranche was released a couple of months late although the GOC still had not met all of the targets. There is evidence that other tranches were delayed but often this was due to GOC tardiness in submitting the information required for the review; in other instances AID/W raised questions about compliance and this, too delayed some tranche releases.

In general, one can reasonably argue that A.I.D. provided a credible enforcement of loan conditions even though enforcement never required the actual deobligation of funds. In a world of imperfect forecasting, ex post judgment must always reassess the appropriateness as norms for satisfactory performance of conditions set down in agreements made many months before. Ultimately, fulfillment of the spirit of the original commitment must serve as the test of honest effort required for the release of loan funds. The record of enforcement of loan conditions in Chile scores well according to this view of the problem.

C. Environmental Factors

1. National Politics

Domestic political factors were the greatest single obstacle to A.I.D. leverage throughout the loan period. In 1963-64 and again beginning in 1969, the national election campaigns generated strong opposition to government efforts to slow inflation by limiting public sector wage adjustments and increases in other parts of the budget.

Between campaigns, vested interests, operating through the Congress, delay and/or seriously weakened reform legislation sponsored by the administration. For instance, it required two years of Congressional debate on agrarian reform before the necessary legislation was approved in mid-1967. And pressure from the military forced wage increases in excess of GOC commitments. In general, the vigorous quality of Chilean political combat and the ruling party's need to maintain alliances with other parties in order to win Congressional consent to its program greatly weakens the ability of any GOC administration to carry out a broad range of effective reform measures within the short term of 3 or 4 years (between national election campaigns) when it can best function.

2. U.S.-Chilean Relations

While American interest in GOC policy towards the copper industry and similar national concerns occasionally produced tense moments, the period was generally marked by exceptionally smooth U.S.-Chilean relations. The Frei Government in particular was viewed as an almost ideal partner in advancing the goals of the Alliance for Progress. Even the GOC decision to forego aid in 1967 -- with all its unhappy consequences -- reinforced the favorable Chilean image since A.I.D. foresaw difficulty in justifying program assistance in a year of rising copper prices. The exceptionally productive relationship with Chile over this period must largely be credited to the competence and diplomatic skill of the Mission Directors and staff.

3. Multilateralism

Multilateral forces influenced A.I.D.'s leverage in several ways. First of all, there has been a tradition in the Americas that countries can enter into international treaties that simultaneously further national and international interests, a tradition embodied in the history of the Organization of American States. The Alliance for Progress grew out of this political cast of mind and succeeded in reconciling the requirements of national sovereignity with exacting conditions of performance for the transfer of resources on a concessional basis from the United States to the Latin countries. The sweeping reform objectives of the Alliance and its understanding of performance conditions for aid were a genuinely multilateral contribution to the U.S.-Chilean experience with program loans.

More specific multilateral influence on the program loans came from two quarters. The IMF laid down specific monetary and fiscal policy conditions in granting annual standby facilities. Fulfillment of IMF standby conditions was a standard commitment in the program loan agreements and the leverage obtained on GOC policy was largely attributable to A.I.D.'s insistence on the IMF negotiations. Another source of multilateral influence was the CIAP. The GOC program was subject to annual CIAP review and criticism and the Chilean Government formally expressed its policy commitments in a subsequent letter to the CIAP secretariat. However, multilateral influence was minimal in this instance. CIAP served largely as an acceptable recipient of the Letter of Intent formalizing the conditions of program assistance negotiated earlier with A.I.D.

In the early sixties, there was also some discussion of establishing an international consortium under the leadership of the World Bank to serve as a consultative group of source of aid. However, Chilean interest in the project faded quickly when program assistance on balance of payments grounds was offered by the U.S.

V CONCLUSIONS

The program loan experience with Chile suggests the following broad conclusions:

1. The series of program loans since 1963 gave A.I.D. significant leverage on GOC development policy. Many loan conditions were largely met and some progress was made on the control of inflation and on improved government monetary and fiscal policy. The periodic review of performance and the requirements of loan and standby negotiations induced the Chilean Government to adopt its own regular internal reviews of policy.

2. The sector loan is probably a useful way of dealing with performance targets in sectors not directly under the authority of the Minister of Finance. The separate treatment of these goals engages the officials directly responsible for these areas of policy and limits the threat of tranche delays or deobligations to the sectors where nonperformance is expected to occur.

3. The specification of loan conditions as exact quantities which A.I.D. regards as guidelines for performance exposes the Mission to criticism for arbitrariness when performance falls short of the targets. It is critically important for the preservation of mutual trust that A.I.D. and the host government have some prior understanding of what would constitute an acceptable margin of error. The Chilean experience illustrates this kind of mutual understanding.

4. Program loans provided strong support for the effort of the Frei Government to undertake a broad range of difficult policy reforms. The experience with Chile shows that a leverage relationship is viable with a government of a reasonably democratic and coup-free country.

5. Finally, program assistance need not be emphatically multilateral in order to yield effective leverage on policy. Multilateral influence is helpful, but it is not essential when a government like the GOC is responsive to suggestions in a bilateral arrangement.

COLOMBIA

by

Donald R. Snodgrass

March 1970

PROGRAM LOAN STUDY: COLOMBIA

COLOMBIA

I. INTRODUCTION

A.I.D. has made seven program loans to Colombia, involving gross obligations of $373 million. Since FY 1963, Colombia has been an important proving ground for program loan leverage, using many of the procedures and techniques later applied elsewhere, particularly throughout Latin America. The case of Colombia must thus be an important part of our evaluation study.

A.I.D.'s experience with program lending in Colombia is chronicled in the following section. It begins with a rather haphazard balance of payments loan in FY 1962 and proceeds to increasingly ambitious and sophisticated attempts to use U.S. money to influence Colombian policy. This trend toward more elaborate program loan conditioning, in which the FY 1963, 1964, 1966, and 1967 loans all marked successive steps, is punctuated by unexpected, sometimes violent, breakdowns in relations between the GOC and the aid agencies (IMF, IBRD, and A.I.D.). These breakdowns occurred in late 1964, late 1966, and early 1968. The last of these seems to have produced a strong reaction to formal loan conditions on the part of the GOC and President Lleras personally. It has in fact helped reverse the trend toward specific, multiple conditioning; the FY 1968 program loan, signed recently, is less formal in its policy conditioning than its precedessor.

Conclusions which emerge from the Colombian experience on the basis of this study are reported below, following the chronological account. It should be noted in advance, however, that Colombia's development problems in general and attempts to achieve leverage from program loans in particular are heavily influenced by two cardinal facts, one economic and one political:

1) Colombia's development is hampered by severe structural problems, particularly by dependence on coffee for two-thirds of export receipts. These rigidities are so constraining on development efforts and so slow to yield to attempts to modify them that they put a severe limit on the speed of possible progress in Colombian development generally. (It is <u>not</u> clear, however, that Colombia's development problems are inherently more intractible than those of the other countries included in this study.)

2) Colombia possesses an unusual political system, which combines free elections with complex regulations designed to maintain political stability. This National Front system, a legacy from an earlier era of political turbulence, rotates the presidency between the Front's constituent Liberal and Conservative parties. It is a profoundly conservative arrangement, as evidenced by the rule (which has been suspended in emergencies and modified by special legislation last year) that legislation of major substance can be enacted only with a two-thirds Congressional majority. The system provides a unique coupling of two undesirable features from the development point of view: biennial departures from national discipline in an attempt to win the election and absence of a usable mandate for whichever candidate does eventually win.

II. CHRONOLOGICAL ACCOUNT OF COLOMBIAN EXPERIENCE

A. Pre-1962

Prior to A.I.D.'s first program loan in FY 1962, U.S. assistance to Colombia was limited. The first A.I.D.-type project loan was made in FY 1961. Longer standing forms of aid consisted of a small technical assistance program and some PL-480 loans and grants. Combined, these types of assistance averaged about $11 million annually in the last four years before inauguration of the Alliance for Progress. In addition, the ExIm Bank was a large but irregular lender. The IBRD entered Colombia as a consistently important source of finance in FY 1959 and has continued in this role, with a one-year break in 1965, ever since. In FY 1961 the IDB made its first loan to Colombia; its gross obligations have hovered close to the $25 million mark each year since. Non-U.S. bilateral aid was, and continues to be, negligible.

B. FY 1962: $30 million Contingency Fund loan

Program loan activity in Colombia began at the initiative of the GOC, well in advance of an established rationale or procedure for such lending on the part of A.I.D. (although after conditioning language had been appended to a Brazil program loan). The following paragraph, from an early 1962-memo, suggests the mood and methods of the times:

> "On December 12, 1961, the Colombian Government requested through our Embassy in Bogota $120 million in balance of payments assistance on an urgent basis. There had been no advance warning that the GOC would require large-scale balance of payments assistance in 1962, in addition to the $110 million in U.S. Government and IMF balance of payments funds drawn in 1961. Our Embassy immediately began an investigation of the Colombian balance of payments prospects for 1962. The newly appointed Minister of Finance, Jorge Mejia Palacio, visited Washington in early January 1962 to reinforce the request made in Bogota in December. An inter-agency task force which had been studying the available data concluded that it would be helpful to have a further investigation of the actual data in Bogota. An A.I.D. technician went to Bogota, and together with Embassy officers and GOC officials, developed a revised and agreed estimate of the prospective Colombian balance of payments figures."

The compelling rationale for the loan was a large anticipated payments deficit in the first half of CY 1962. Since overthrowing dictator Gustavo Rojas Pinilla in 1958, Colombia had been following an austere monetary and fiscal regimen. During 1961, however, in preparation for the national elections scheduled for the following March and May, the Government had been loosening up considerably. Import deposit requirements had been removed, public expenditures increased, the discount rate lowered, and credit controls eased. The prospective payments deficit could thus be attributed directly to weak policy. Should A.I.D. reward irresponsibility--especially after having made three other "emergency balance of payments loans" to Latin American countries earlier in the year? In deciding to go ahead with the loan, A.I.D. cited offsetting GOC achievements (including preparation of a 10-year plan) and resolved to press for policy improvement (with devaluation left beyond the pale until after May).

From surprise request to loan authorization took only two months (although two more months elapsed before the loan was signed). The size of the loan was drastically reduced by shortening the time frame and allowing for debt rollovers, reserve drawdowns, and a return to import deposits. There was apparently some discussion of GOC policies, and one high-level memo reports that the GOC "is now prepared to undertake all of the financial and economic reforms which we have made prior conditions for this loan." However, I could find no other references to policy conditions. Neither the loan authorization nor the loan agreement mentions any and there is no record of subsequent review of GOC performance. All funds were released after legalistic conditions precedent were declared met.

C. FY 1963: $60 million program loan

Following the signing of the $30 million CF loan in April 1962, a series of events which were highly favorable from the U.S. viewpoint took place:

1) The National Front won the national elections, which were carried out in an orderly fashion. The newly elected President (Valencia) and his Finance Minister (Sanz) declared their commitment to development and far-reaching fiscal reform.

2) The ten-year plan received an endorsement in principle from the "Nine Wise Men" of the OAS and from the IBRD, which undertook to organize a consultative group for Colombia.

3) The rate of monetary expansion was reduced.

4) Import deposit requirements were increased.

On the strength of these encouraging signs, A.I.D. took up the question of financial support beyond the first half of 1962. An early conclusion was that some form of devaluation was needed. The IMF, which had reached the same conclusion, began discussions with the Ministry of Finance to work out a package which would serve as a prerequisite to an IMF Stand-by. In October the Country Team said that the U.S. would "urgently consider" a $60 million loan, should Colombia "adopt acceptable fiscal, exchange, and monetary measures." After some discussion, it was agreed that the acceptability judgment would be delegated to the IMF. On November 7 the Ministry of Finance introduced in Congress a wide range of legislative proposals embodying the policy changes worked out with the IMF and IBRD. (A.I.D. appears to have been kept informed and cheered the participants on, but does not seem to have been directly involved in designing legal and policy changes.)

The policy package included a de facto devaluation from 6.7 to 9 pesos/dollar for most transactions, with exporters of coffee, petroleum, and hides left behind near the old rate. It also included increased consumption and inheritance taxes. The new revenues to be generated was estimated at 1,020 million pesos annually. In addition, bank reserve requirements were increased and the use of the rediscount privilege curtailed. A.I.D. concluded that "together with the monetary measures, the GOC's present fiscal and exchange plan, if adopted, would bring about a sound financial backing for the GOC development program." The loan paper submitted in November urged release of "a substantial portion of the loan ... as soon as exchange reforms acceptable to A.I.D. have been implemented," adding that "such measures are expected in the immediate future." The rest of the $60 million was to be made available later, based on satisfactory implementation of the remainder of the package.

Following the successful IMF negotiations, a U.S. loan agreement was swiftly drawn up. The agreement was signed on December 18, less than two weeks after A.I.D./W authorized the loan. The IMF Stand-by, for $52.5 million, was signed in January.

The new loan agreement introduced the tranche release procedure to Colombia. There were two $30 million tranches. The first half of the loan was released on January 21, 1963 when initial conditions (legalisms plus satisfactory exchange reforms) were declared met. Release of the second half was not prescheduled, but was to come whenever Colombia showed evidence of "providing resources, in addition to those obtained from the . . . exchange reforms, to achieve investment levels called for by /its/ economic and social development plan." The nature of the evidence required was later defined, in an implementation letter, as consisting of four reports:

1) Documentary evidence of tax measures, accompanied by projections of the effects of these measures on revenues.

2) Evidence of appropriate monetary measures.

3) A projection (for 1963 and 1964) of revenues, expenditures and the current account surplus.

4) Data, actual and projected, on prices, exports and imports, investment and saving.

During the first eight months of 1963, while the first tranche was being drawn down, the GOC tried to push its tax proposals through Congress. Resistence was strong and the Valencia administration did not show the vigor A.I.D. would have liked.

Worse, the Minister of Labor was decreeing wage increases far in excess of earlier projections and calling them a necessary adjustment to the recent devaluation. In addition the Bank of the Republic (BOR) was intervening actively in the free foreign exchange market to support the peso. U.S. Government displeasure was conveyed in meetings during July and August to discuss a possible PL-480 agreement and release of the second tranche of the program loan. The use of a Special Economic Powers Law to put through the tax package by executive fiat was put forward as a prerequisite to release of the second $30 million.

During August, the Special Economic Powers Law was introduced in Congress, passed, and implemented by a series of Presidential decrees. In requesting the tranche release early in September, Finance Minister Sanz estimated that the new measures would yield revenues of 340 million pesos in 1963 and 506 million in 1964. An analysis of the reports specified in Implementation Letter No. 1 showed that the new measures no more than offset the effects of the unexpected expenditure increase on the public finances. The GOC was undertaking additional fiscal and monetary measures, but the damage had already been done. The benefits of the devaluation had largely been dissipated.

In evaluating the highly equivocal Colombian performance, the Embassy and A.I.D. Mission chose to be tolerant and look forward rather than backward: "Considering the delays in obtaining Congressional approval which are inherent in a democratic country, and considering the very favorable prospects for the future on both the tax policy and the tax administration fronts, the Embassy and the A.I.D. Mission feel that the delay should be disregarded and the second tranche of the loan released on the basis that tax measures have now been taken to raise revenue both for 1963 and on a full year basis as envisaged in the Loan Agreement." Apparently AID/W took a similar view and release of the second tranche was approved on October 8.

D. FY 1964: $15 million and $45 million program loans

Even before obtaining release of the second tranche of the FY 1963 program loan, the GOC put in a bid for a new loan. The request, for $100 million, was made in July. In reply, the U.S. said it would talk about continued program aid at the $60 million level, plus up to $40 million in projects if the agreed self-help measures were taken and the U.S. Congress appropriated the money. As quid pro quo, the GOC would be asked to negotiate agreed balance of payments and public finance estimates, formulate an export promotion policy, draw up an import budget for 1964, and agree on a tentative list of uses of counterpart.

As negotiations proceeded, it became evident that Congressional elections scheduled for May 1964 limited the willingness of the Colombians to make the policy commitments the U.S. was seeking. Nor were the GOC negotiators willing to make promises about what they would do after the elections. The U.S. did want to maintain import flows and Colombian credit-worthiness during the first quarter of 1964. Accordingly, a $15 million piece was broken out of the year's agreed total for separate negotiation.

As it turned out, the $15 million loan was marked by protracted delays in negotiation and activation. A U.S. proposal was not firmed up until January 1964. It called for three policy conditions precedent: (1) a quantitative current account government surplus target (tentatively set at 200 million pesos in the first quarter and 1,100 million for the year), (2) an export promotion policy, and (3) a 1964 import budget. After long discussions of these conditions, and of A.I.D.'s asserted right to specify the commodity list unilaterally, the loan was signed on March 11. In its final form, it retained the annual surplus of 1,100 million and the import budget as explicit policy conditions but dropped export promotion and, as one would expect by this time, the first-quarter surplus.

Although the loan was signed in March 1964, the conditions precedent were not met until late July and the first disbursement was not made until November. These long lags were attributed by one cable to the fact that the loan was signed by a brand new Finance Minister, Diego Calle Restrepo, who had alienated both his Cabinet colleagues and a committee of Congress by signing the agreement without their formal approval.

Sometime earlier, in April 1964, separate discussions had begun on the additional $45 million earmarked for program assistance in FY 1964. Early 1964 saw rising coffee prices and improved near-term economic prospects for Colombia. On the other hand, the May Congressional elections produced gains for the Left and weakened the Government's resolve to follow austere economic policies. Under the circumstances, the Mission stuck to its prior aid proposal, but only if Colombia would foreswear any significant further increase in short-term foreign debt and any expansion of the recently-formulated import budget for 1964. The situation called for a sharpened definition of program loan policy conditions and the Mission responded with a proposal for a much more detailed and structured system than had been used before. It established all the basic characteristics which have marked program loan activity in Colombia ever since.

The loan paper prepared to request A.I.D./W authorization to negotiate (which was granted on May 14) specified eight performance commitments to be sought from the GOC. Together, they comprised a much more comprehensive and specific attempt to influence Colombian policy than had been essayed earlier. The eight areas covered were:

1) Short-term foreign debt (limit expansion of private debt, reduce public debt).
2) Import level (keep original 1964 budget).
3) Export expansion (formulate program).
4) Agricultural planning.
5) Education.
6) Monetary policy.
7) Budget policy (a 1,100 million peso target for the current account surplus was stated to be a minimum negotiating objective).
8) Tax administration (several specific steps were mentioned).

Despite some internal debate, the U.S. Government decided not to make exchange rate adjustment a condition of the loan. The predictable unpopularity of devaluation within Colombia, plus a belief in some quarters that economic stabilization could be achieved through sole reliance on monetary and fiscal restraint, provide the reasons.

The loan paper went on to say that "as soon as the present proposal is achieved, the Director of the USAID will negotiate the authorized amount and the proposed performance commitments with the Colombian Minister of Finance and other appropriate Colombian officials. As part of this negotiation, he will seek to persuade the Minister of Finance to set forth in a letter his Government's program for 1964 in specific terms of undertaking to comply with the eight performance commitments which are the basis for justifying this loan proposal." The letter, the paper added, could be sent to the IBRD or the OAS Ad Hoc Committee on Colombia rather than directly to A.I.D., if the GOC preferred.

"While the GOC's performance commitments would be expected to be stated in the proposed letter, the U.S. commitment of funds under the $45 million loan will be contained in a separate loan agreement. On the assumption that the Minister's letter will in all respects state his intentions in an unambiguous manner, satisfactory to A.I.D. as a basis for judging eligibility for disbursement, the substantive portions of the loan agreement would be confined to a specific reference to the Minister's letter and to the establishment of provision for two reviews of progress in addition to that which takes place in May as part of the negotiations . . . the loan agreement should specify that the GOC and the U.S. would conduct a full review of progress on all points in the Minister's letter, with such reviews to take place in August and November 1964. As soon as the USAID concludes that the results of each review are satisfactory, disbursement of the next tranche will be approved. USAID will report its fundings by airgram for the information of AID/W."

Except for the attempt to give the Mission the sole right to approve tranche releases, this 1964 proposal embodies what has come to be knows as "the LA system."

Negotiation of this elaborate set of policies and procedures seems to have gone reasonably smoothly. On July 17, Finance Minister Calle dispatched his Letter of Intent to the U.S. Embassy. Together with a side memorandum, it embodied all the commitments the U.S. sought. Signing of the loan agreement followed on July 13.

The new agreement specified three tranches: one of $20 million to be made available when the GOC supplied its self-help program; a second of $15 million to be released after a review of Colombian performance and prospects in September or October 1964; and a third of $10 million to follow another review in January 1965.

Nothing went right after the loan agreement was signed. Months were consumed in negotiating sticky implementation questions involving forward commitment procedures and marine insurance. As these months passed, the GOC and Colombia's Coffee Federation were running large deficits, wh'ch in turn were being reflected in a worsening balance of payments. Mission and Washington officials, jointly appraising the situation in November, saw mixed performance, with slippage on the short-term debt, import, and tax conditions of the loan. Nevertheless, "on balance, we conclude that GOC performance in 1964 has been sufficiently good to warrant continuation of disbursement of existing loans." The first tranche of the $45 million loan could be released as soon as the implementation issues were cleared up, although release of the second tranche would be conditioned on actions to come closer to the loan agreement's policy terms. On December 10 a revised PAAD was signed, giving the U.S. negotiators additional flexibility on forward procurement and marine insurance.

In December speculation against the deteriorating foreign exchange position flared up. Total insolvency loomed and a near-moratorium was imposed on foreign payments. Pressure on the GOC mounted. Assurances of new foreign aid would halt the speculation but negotiations remained deadlocked.

As 1964 came to a close, the U.S. began stepping up the pressure for devaluation. By December, the implementation questions nominally being negotiated had ceased to be the real points at issue and became a facade behind which the debate on devaluation was being held.

Finance Minister Calle was prepared to give in. He agreed to a devaluation and exchange reform package, and on December 19 he formally proposed a compromise solution to the outstanding implementation issues. A few days later, the U.S. accepted his proposal and agreed to release the first two tranches--despite the lack of the performance review specified as a pre-condition to release of the second tranche, and despite Colombia's patent failure to meet many of the policy conditions cited in the loan agreement; the basis for this decision was a feeling that the U.S. was too deeply committed to Colombia to have any choice. Only the $10 million third tranche was held back, pending the performance review scheduled for January. But as things turned out the review was never held. President Valencia vetoed Calle's proposed exchange reform. As late as January 26, 1965, Calle was still asserting that the review would be held, but a few days later he resigned. His successor, too, stalled. U.S.-Colombian aid relations ground to a standstill. Ultimately (November 1965) the third tranche was deobligated.

E. FY 1965: No program loan

During the remainder of FY 1965 the GOC remained at odds with A.I.D., the IBRD, and the IMF. The aid agencies were fighting for acceptance of an integrated policy package, the main components of which were exchange devaluation, increased taxes, and an end to subsidization of coffee production. Despite heavy pressure within the U.S. Government to mend its relations with Colombia, A.I.D. continued to regard all these as necessary preconditions to either release of the last $10 million of the FY 1964 loan or any new loans. Meanwhile, the economy drifted. Foreign exchange pressure continued, the free rate depreciated by 50%, imports and investment were severely constrained.

In February a Grand Commission, composed of leading economic interest groups, was convened to study the nation's economic problems. A special session of Congress was called to act upon the Commission's recommendations and Finance Minister Duran's plan for financing them. Duran had reopened negotiations with the U.S. and IBRD, but like Calle before him he was overruled by President Valencia and other members of the Cabinet and proceeded into retirement. The succeeding months saw continued drift and a series of futile Finance Ministers.

F. FY 1966: $65 million program loan

The failure of the Duran Plan and the continuing government impotence ultimately turned business and financial interests, normally supporters of Valencia's Conservative Party, against him. They brought pressure to bear and in July 1965 prevailed upon him to give both the Finance portfolio and a mandate to do something with it to their own candidate, Joaquin Vallejo Arbalaez. Vallejo promptly drew up proposals for exchange reform, an income tax surcharge, and obligatory bond purchases, and submitted them to Congress. After six weeks of legislative procrastination, the government used its State of Siege powers to enact Vallejo's proposals by executive decree.

Responding to this long-sought cue, A.I.D., the IMF, and the IBRD reopened discussions. Agreement on policies and amounts came swiftly. A new program loan was authorized on November 9. There was a temporary pause while Vallejo guided a large wage increase for government employees to completion, and when this was done without exceeding estimates the new loan, for $65 million, was signed on December 20. In the press release, emphasis was placed on a $102.5 million, 12-month U.S. aid package (the remaining components of which were $10 million in PL-480, $15 million in ExIm Bank guarantees and insurance, and $12.5 million in the form of a Treasury Exchange Agreement). On January 1, 1966, an IMF Stand-by credit of $36.5 million was added to the pot.

The FY 1966 program loan represents a mature flowering of the "LA system." In a Stand-by with the IMF, a memo to the IBRD (in its role as head of the Consultative Group), and side letters to A.I.D.--all of which were regarded as vehicles for program loan policy commitments--the GOC pledged itself to a comprehensive, integrated policy package. The package comprised 73 separate measures, many of them quantified or otherwise tightly specified. Funds were to be released in four tranches, the last three of which would be subject to favorable findings in quarterly performance reviews. The reviews were timed to coincide with quarterly tests under the IMF Stand-by.

During most of CY 1966, experience under the $65 million program loan seemed generally quite favorable. Reviews held on schedule in February-March, May, and July-August all produced recommendations for release of the tranche under consideration. The performance reviews were extensive and searching and involved large numbers of officials on both sides. The results were conveyed to Washington in well-organized airgrams of 100 pages or more.

Emphasis during the year was on effective follow-up on the Vallejo reform program. All were anxious to avoid the backsliding which had nullified the 1962 devaluation. Up to a point, this effort met with considerable success. An independent Washington staff review in the Fall of 1966 found that "the Government had met or exceeded the targets established as regards foreign exchange reserves, central bank credit expansion, expansion of the means of payment, fiscal operations, and import liberalization. In particular, balance of payments developments have been very favorable. Only 15% of imports . . . are currently under license. Raw materials supplies have been sufficient to make possible a business recovery. While the cost of living has risen by about 1/3 the amount of the devaluation, inflationary pressures appear to have eased in recent months." On the other hand, "in areas where institutional changes were required by the commitments under the program loan . . . performance was less satisfactory." These areas included development planning, agricultural prices, public administration reform, and export promotion. "Coffee policy also fell short of targets, in part because of a decline in external prices."

An important factor in the improving picture during the program loan year ending in September was the victory of the National Front, led by incoming Liberal Party President Carlos Lleras Restrepo, in the Spring elections. On March 20 the Front rang up an unexpected 55% majority in the Congressional elections (although 60% of eligible voters failed to go to the polls); in the Presidential election which followed on May 1, Lleras scored an unprecedented 71% landslide. At the time, this seemed to most observers a remarkably strong mandate, which left the GOC in a better position to act than at any time since 1958. However, some retrospective political analyses have stressed the precariousness of Lleras' position vis a vis Colombia's divergent political interest groups and his consequent need to build popular support through nationalistic appeals. This, it is argued, explains much of his subsequent behavior toward the aid agencies.

G. <u>FY 1967: $100 million program loan</u>

Despite the favorable review it received up through the Fall of 1966, Colombia was on the brink of yet another spectacular exchange crisis. As mentioned earlier, Colombia liberalized its imports during 1966 substantially in excess of the degree required by the program loan (the loan specified 50%, but actual liberalization exceeded 80%). (The reason for this high degree of liberalization is obscure; perhaps the most plausible hypothesis is that the GOC foresaw further liberalization as a likely condition of the next program loan and acted to avoid having the move forced upon it.) In response to this liberalization, imports rose sharply in each of the first three quarters of 1966, nearly doubling over the nine-month period as a whole. When coffee prices dropped in the third and fourth quarters and Colombia responded by trying to hold coffee off the world market, foreign exchange reserves came under severe pressure. A U.S.-IMF-IBRD meeting in July had partially foreseen this reserve squeeze but decided there was no need for extraordinary action provided the U.S. and IMF were willing to extend new loans before the end of the year, as they then planned to do. By September, however, the situation was worsening and speculative tendencies were building up. President Lleras, in a meeting with the A.I.D. Mission Director, ruled out devaluation but offered two alternatives: negotiation of new aid soon or reimposition of direct import and exchange controls. The GOC requested accelerated negotiations and a $17 million first tranche on an advance commodity financing (ACF) basis. The hands were dealt in a poker game which was to continue through the Fall.

The game consisted of a complex series of moves, in which the IMF tried to bring about devaluation with U.S. and IBRD support, while the GOC attempted to stave it off by obtaining additional financing. The U.S. said it opposed using a 40-year development loan to solve a short-term exchange problem. The GOC was urged to pursue other sources of finance: a possible loan from the Venezuelan central bank, conversion of bilateral trading balances into liquid exchange, a loan from Spain using Colombia's large trading balance as collateral, debt rollovers, loans from New York banks.

The U.S. said that ACF and a rollover of Colombia's gold loan from the Federal Reserve system were ruled out by the U.S. balance of payments problem. Colombia in turn rejected or was unable to achieve several of the solutions put forward by the U.S. New York banks gradually emerged as the most likely source of supplementary financing but the banks, surprised and alarmed at the size of the separate loan requests made by the GOC and the Coffee Federation, imposed tough loan conditions, which the GOC finally rejected on November 11.

Negotiations between the GOC and the aid agencies continued, with first the Fund and then the Bank taking the lead. Several options on the timing and explicitness of the devaluation were offered, but President Lleras, while recognizing the strength of the technical case for exchange rate adjustment, would make no commitment of any kind. On November 29, in a surprisemove, Lleras went on television to denounce the aid agencies for their "interference in Colombia's internal affairs." Once again, aid relations had completely broken down.

Having demonstrated his independence and ability to withstand intense pressure (and increased his popularity in the process), Lleras was faced, on the morning after, with the fact that he had not solved Colombia's fundamental foreign exchange problem. Under the circumstances, he moved with surprising speed to restore good relations with the aid agencies. An IBRD team was invited down to analyze the situation, and its carefully worded critique was well received by the GOC. IMF negotiators returned and helped elaborate a embryonic Colombian proposal for a new exchange system. The new system involved two rates, the lower of which would float upward toward unification with the other, thus allowing for substantial de facto devaluation.

With the new system agreed upon, President Lleras still refused to commit himself to a date for its installation. In desperation, the Fund scheduled its Board meeting on the subject for March 22, saying that if the lower rate had not started moving by then the meeting would be postponed. The rate did start to move in mid-March and the new Stand-by was announced on schedule. With good GOC-IMF relations restored, A.I.D., too, resumed negotiations. A $100 million program loan was authorized on May 2. The loan, which was signed on May 27, was very similar in structure to its immediate predecessor. There were four tranches, the first (of $40 million) conditioned on the signing of a Stand-by agreement with the IMF and the last three ($20 million each) to follow quarterly performance reviews. Specific policy conditions, including those incorporated by reference to GOC letters to the IMF and IBRD, numbered 71. (However, to make the initial review held in July-August more manageable, it was agreed that certain subjects would be deferred for later consideration.)

The policies for which the U.S. was pushing in the 1967 loan were much the same as in past years. Movement toward an equilibrium exchange rate coupled with a limp promise to resume progress toward trade and payments liberalization (the GOC "calculated it will be possible gradually to introduce import liberalization to reach an amount equal to 20% of reimbursable import registrations") headed the list. Elimination of inflationary influences from monetary, fiscal, and coffee policies ranked high. Export promotion, development planning, and agricultural and educational reform were also included, as in past years. A new feature was that U.S. export additionality was explicitly mentioned in the loan agreement: commercial imports from the U.S. in any three-month period were not to be "substantially less than the recent historical ratio."

The first quarterly review, which covered the second quarter of 1967, gave the GOC generally high marks in the areas it covered. Minor difficulties were identified in some fields but no explicit loan conditions were missed. The second review took place in November. It, too, revealed generally strong performance. Indeed, the foreign exchange reserve picture had improved so much that A.I.D. and the IBRD urged that the import liberalization target be raised about 20%. The GOC rejected an increase in the target, but promised to attain the 20% level by March 31, 1968. The Bank and A.I.D. replied that import liberalization would be a major issue in 1968.

The final review under the 1967 loan dealt with the fourth quarter of the calendar year and was held in February, 1968. Like its predecessor, it concluded that Colombian performance on the great majority of the 71 policy issues was satisfactory. There was, however, one black spot. The U.S. share in commercial imports had fallen from the historical figure of 39% to only 21% in the fourth quarter. Weighing GOC promises to take corrective action, the Mission recommended release of the tranche. Washington pondered, waited for January and February trade data, and finally, in late March, authorized release of the tranche.

Meanwhile, though, another cloud was gathering. The GOC had been stalling on the 20% import liberalization promised for March 31. As the deadline neared, negotiations on 1968 program and agricultural sector loans and a new IMF Stand-by were underway. On March 19 the GOC startled the donors by announcing that it could not go through with the liberalization until the fourth tranche was released and the new Stand-by signed. Washington immediately withdrew its authorization for release of the fourth tranche.

H. FY 1968: $58 million program loan; $15 million agricultural sector loan

Although the U.S. took the position that it could not sign new loans while Colombia remained ineligible for the final tranche of the FY 1967 program loan, negotiations were never broken off. Bad feeling had been created, however, and progress came slowly. The GOC shied away from explicit commitments on exchange rate flexibility, import liberalization beyond 20%, incentives for minor exports, and improved tax administration. Lleras personally expressed a strong distaste for specific, arithmetic, rigid targets and dates. Nevertheless, after the GOC came through with its promised liberalization in April and the fourth tranche was released, negotiation of the two new loans--for $58 million and $15 million respectively--was successfully completed.

In the light of Colombia's dramatic history with program loans, it is interesting to examine the latest such agreement. It is generally similar in structure to the 1966 and 1967 loans, though simpler and less ambitious in some respects. The loan is to cover a nine-month period (the last three quarters of CY 1968). It is in two tranches, $35 million to be released upon satisfaction of legal conditions precedent and the remaining $23 million conditioned on a review of performance through September. A total of $12 million is reserved for imports of capital goods. The policy areas covered are foreign exchange and trade policies, additionality, monetary policies, fiscal policies, coffee, industrialization, and unemployment. On several of the points which have been most sensitive in the past, wording in the 1968 letters to the IMF and IBRD is noticeably looser than in the past two years. This is particularly true with respect to depreciation and unification of the exchange rate, export incentives, and arrears in foreign payments. (While outlining the principles of its exchange rate policy orally, the GOC has scrupulously avoided committing itself to any specific rate of depreciation.) There is no fixed target for trade liberalization, although the GOC does agree either to liberalize imports or to increase import registrations by an amount equal to the margin by which coffee exports exceed the predicted figure of $5.5 million. On the other hand, U.S. export additionality is much more prominent than in the past. The GOC pledges itself to a number of specific measures to help maintain the historical market share of the U.S.

Agriculture and education have been taken out of the program loan and isolated for separate treatment. No education sector loan has yet been signed. In the FY 1968 agriculture sector loan the "LA system" is applied to a single sector. The loan has two tranches. Release of the second ($7 million) is conditioned on a review of performance through September. Nine tightly-specified performance commitments are listed. In all, they appear to constitute a somewhat more complete specification of desirable agricultural policy than was made in earlier program loans.

III. THE PRINCIPAL ISSUES

A. Did A.I.D. try to use the program loan to influence policy?

The FY 1962 Contingency Fund loan was obviously processed in a hurry. It does not seem to have carried any meaningful policy conditions. However, A.I.D.'s second program loan, in FY 1963, clearly grew out of an Alliance-kindled interest in development plans and policies. The first of its two tranches was conditioned on the December 1962 devaluation and exchange reform. Its second tranche was supposed to be tied to completion of the follow-up actions necessary to make the devaluation stick (essentially, new taxes and temperate monetary policy). GOC performance on the actions specified was mixed, but the worst damage was done by actions in an area not covered by the loan's policy conditions--wage increases for private and public sector employees. One gets the impression that after this experience a conscious decision was made to be much more careful and comprehensive in specifying loan conditions. From FY 1964 on an increasingly serious effort was made to exert leverage in an increasing number of fields.

FY 1964 program loan funds were split into two separate loans precisely because of this determination to improve GOC policies. The first loan, of $15 million, set relatively easy conditions, since these were all that could be obtained on the eve of Congressional elections. The second loan, of $45 million, was negotiated at a time of rising coffee prices and represented an attempt to ensure efficient use of the additional resources being generated. It was the first attempt at a comprehensive policy framework. The attempt was abortive, however, since the wrong policy prescription may have been written and GOC policy progressively deteriorated during CY 1964 in any case. This lead to the exchange crisis in December, the unsuccessful attempt of the aid agencies to bring about devaluation, and the break in aid relations.

When the GOC finally pulled itself together in late 1965, negotiations were resumed and eventually consummated in the $65 million FY 1966 loan. This loan and its $100 million successor in FY 1967 represent highly ambitious attempts to specify a policy framework for Colombia, embracing not only stabilization but also growth, not just aggregate policies but also considerable sectoral detail. The FY 1968 loan continues this policy emphasis, although it represents a partial retreat in terms of amount of action required of the GOC as a condition of the loan.

There can be no question about whether the U.S. had tried to influence policy in Colombia in recent years. For better or worse, we have chosen Colombia as the recipient of sizeable development resources and have deeply involved ourselves in her development policies. In close coordination with the IMF and in virtual lock-step with the IBRD we have generated and tried to bring about proposed policy changes in virtually every subject with an important relationship to development.

B. Did Colombia perform?

How well have the Colombians lived up to the conception we and our Bank and Fund allies have had of what constituted desirable Colombian performance? The record here is an intriguing mixture of short-term performance and the seemingly inevitable persistence of major problems in the longer run.

As already noted, the FY 1963 and 1964 loans were pretty clear-cut failures from the leverage point of view. Much of the letter and all of the spirit of the FY 1963 loan were violated. The FY 1964 loan conditions did not fare much better.

Performance under the FY 1966 and 1967 loans, which represent our most earnest attempts to obtain influence in Colombia, is more difficult to judge. In both cases, the multitudinous policy conditions specified, many of them very firmly, were conscientiously reviewed and reported on each quarter. These reviews were honest, searching, and competent. By and large, they are a record of conditions met.

An analysis of the three performance reviews under the FY 1966 loan reveals that an average of 84% of the loan's 73 separate policy undertakings were reviewed each quarter (not counting conditions which were irrelevant to a particular quarter's review). There were 174 individual instances of commitments being reviewed. My own analysis of these instances yields a score of 116 commitments clearly met, 23 reviews commitments clearly missed, and 35 outcomes ambiguous. Thus 67% of the individual reviews found acceptable performance, and only 13% clearly unacceptable performance. Of course, this takes no account of the relative importance of the various commitments.

A similar analysis of the FY 1967 loan, which had 71 separate policy conditions, shows a somewhat lower degree of diligence (71%) in reviewing the conditions specified in the loan agreement and supporting documents. However, the review findings were even more consistently favorable: there were 97 instances in which conditions specified were clearly met, only 6 in which they were not, and 33 in which performance was questionable but not clearly unsatisfactory. Thus 71% of the individual reviews revealed acceptable performance, and only 4% clearly unacceptable performance.

Contrasting glaringly with these apparently strong records of performance commitments met are the exchange crisis which marred the end of 1966 and the furor early this year over nonattainment of the import liberalization and additionality conditions. Two years in a row, generally positive findings of searching reviews were immediately followed by crisis. This is a phenomenon which challenges the whole loan conditioning process as it has been applied in Colombia. It must be explained.

In late 1966 the GOC had the problem of adjusting to the return of coffee prices to their previous level from a temporarily higher plateau. The GOC had been unable to discipline itself and its people to bring off this kind of transition in the past and, despite high U.S. hopes for the Lleras government, it proved unable to do it in 1966. It greatly complicated the problem by liberalizing imports at a reckless rate, in advance of assured means of finance. Once in a tight foreign exchange bind, it sought additional foreign financing to pull itself out. The aid agencies, while open minded about dates and forms, insisted on significant exchange rate adjustment as the sine qua non of further aid. President Lleras not only rejected this condition on political grounds but strenuously objected to all such conditioning on grounds of principle. One searches in vain for signs that overly rigid bargaining positions or faulty communications contributed significantly to the November blow-up. Soon afterwards the aid agencies won their point on exchange rate adjustment (though not without rearguard actions by the GOC), but they had suffered serious losses (so far unremedied) with regard to import liberalization, exchange decontrol, and--most important of all--the GOC's receptivity to aid conditioning in general. Yet it is not evident that the aid agencies could have avoided the crisis without abandoning their basic condition for future aid.

Again in 1968 there was erratic behavior by the GOC. It procrastinated its commitment to liberalize 20% of its imports until late in the program loan year, by which time uncertain financing prospects made it balk at taking the step. Nevertheless, it must be reiterated that the GOC performed very well on the overwhelming majority of the conditions set in the 1967 loan. Moreover, the initial cause of delay of the fourth tranche was not liberalization but additionality. Although additionality had been stressed in earlier reviews it is not obvious that the GOC could have known it could constitute grounds for nonrelease of a tranche. Indeed, the U. S. Government seems to have belatedly increased the weight assigned to this factor, partly as a result of Treasury-Commerce pressure on State-A.I.D. and partly so as to use the additionality question as a means of gaining time for the outcome on liberalization (which clearly was an important issue) to become clarified. Thus the U.S. does seem to have changed the rules on the GOC after the fact. To the extent that Colombia's failure to liberalize was a reaction to nonrelease of the tranche over the additionality question, this contributed to the crisis. After the Colombians abrogated their liberalization promise the U.S. was clearly right in its refusal to release the tranche, since giving way on this key issue would probably have destroyed the capacity to exert leverage in the future.

There is, however, a more fundamental sense in which Colombian performance over the program loan period should be tested. This is the question of significance, or ultimate effectiveness: did the principal economic and social variables A.I.D. was trying to influence through program loan leverage show any tendency to move in the desired directions?

The principal policy objectives pursued through program loan leverage have been quite stable over the period studied. They can be stated as:

1) Attainment of price stability at an equilibrium exchange rate and an adequate level of investment.

2) Lessening of the foreign exchange constraint on growth through promotion of non-coffee exports.

3) Agricultural modernization and diversification.

4) Major reform and improvement of education.

While I cannot claim to pass conclusive judgements, there does seem to have been some limited progress toward these important goals.

1) There has been discernible, though not yet decisive, improvement in the indicators of economic stability. Inflation remained substantial early in the program loan period, but price increases in recent years (and especially in 1967) have been within the tolerable range. There has been considerable success in devising an exchange system which keeps internal inflation from leading to progressive exchange rate overvaluation and diminished export incentives. The GOC has accepted the principle that the exchange rate should move in general step with internal prices, but has refused to make commitments regarding the speed and mechanics of this adjustment. A key to the inflationary problem has long been the GOC's poor domestic revenue performance, averaging 7-8% of GNP, well below most other countries at a similar income level and among the lowest in Latin America. Revenue growth lagged behind GNP growth through 1965, but in 1966 and 1967 striking improvement was effected, with the share of GNP collected reaching 9% for the first time in a decade and real revenues rising sharply above their previous plateau. Considerable progress has been made in raising government capital expenditures. Long extremely low, these more than doubled between 1963 and 1967. The level of total investment remained stagnant, though relatively high (16-18% of GNP), through 1967.

2) Minor exports (all exports other than coffee and petroleum) were stagnant through 1964. In each year thereafter, however, gains have been recorded. Although these gains have nearly doubled the value of minor exports, coffee still accounts for more than 60% of commodity export receipts and development of significant alternative sources of earned foreign exchange will inevitably take a long time.

3) Some promising departures have been made in agricultural modernization, a field in which the GOC is regarded as one of the better Latin American performers. Land reform is underway but still in its early stages. So far, however, the growth rate of agricultural output has remained low.

4) There has been substantial quantitative growth in the educational system, but the kinds of qualitative reforms and improvements we have been pushing for seem generally not to have been made yet.

In summary, then, the record of ultimate performance is mixed. There are achievements to point to in all major fields, but there are also important things which have not yet happened. Moreover, some of the improvements just cited are so recent that one wonders whether they will be sustained, especially since the problem of maintaining development momentum has defeated the Colombians in the past. In any case, Colombia has not yet made a decisive breakthrough to a sustainable high growth path. Although on balance the judgement is positive, Colombia cannot yet be pronounced a clear-cut success for program loan leverage.

C. Did A.I.D. influence policy?

Can the positive, hopeful things that did happen in the areas A.I.D. was interested in during the 1962-68 period be attributed to our interest and attempt to use aid conditioning to bring them about? Or would they have happened anyway, even if we had not tried to lever the GOC into doing them?

One can never answer such questions conclusively. However, it is possible to point to a number of specific things that were done after we expressed considerable interest in them, and in some cases visibly exerted pressure. In such cases, it is a reasonably safe bet that leverage was achieved. A partial list of such cases in the past two years includes the following:

1) The new exchange rate system devised in early 1967.

2) The set of incentives to increase minor exports.

3) Improvement in the finances of the Coffee Federation.

4) Improved procedures for processing private foreign investment.

5) The pilot plan for agricultural diversification.

6) The enlarged public investment program.

D. Can A.I.D.'s influence be attributed specifically to the program loan?

It has already been noted that the U.S. has taken a deep interest in Colombian development, and that we have worked in close cooperation with the IBRD and IMF. A.I.D., the Bank, and the Fund have all been the origin of important ideas about Colombian development policy. The ideas of the three aid agencies have generally been harmonized with each other in a genuine interchange of intellectual equals. As in other countries, the U.S. has sometimes preferred to allow the Bank and Fund to be the main salesmen of ideas to the Colombians, with the U.S. simply conditioning its aid on Colombian agreement with the international agencies. The importance of the Fund and Bank roles in Colombia has derived partly from their role as founts of policy wisdom and partly from their own possession of significant resources which they can provide or withhold at will. The IBRD also draws influence from its responsibility for assessing Colombian performance prior to meetings of the Consultative Group. However, their power has been enormously enhanced by the support given them by the dominant donor, the United States.

The major occasions for the exercise of leverage in Colombia have been negotiations for A.I.D. program loans and IMF Stand-bys. In recent years these two negotiations have been carefully timed by the donors so that they become in effect one negotiation. These annual negotiations write the scenario for the more frequent and detailed discussions which take place through the quarterly performance reviews. Thus, the U.S.-Colombian aid relation has been so structured that leverage focuses on the program loan instrument. The main sanctions for nonperformance are withheld tranches and non-negotiated new loans, although simple delays--sometimes allegedly for nonsubstantive reasons--have also been used to exert pressure.

Program loans have by no means been the dominant form of aid in quantitative terms (they amount to 31% of gross obligations by the U.S. and multilateral bodies in FYs 1962-67 inclusive). However, little effort seems to have been made to influence policy through other forms of aid, such as A.I.D., IDB, and IBRD project loans. Program loans and Stand-bys have apparently been thought of as the principal, if not sole, vehicles for influence. Beginning in FY 1968, sector loans must be added to the list.

IV. DETERMINANTS OF INFLUENCE

A number of hypotheses have been put forth about factors which may affect whether we influence policy with program loans when we try to do so. These hypotheses can only be tested against comparative experience in several countries (if then), but some do emerge as possibly relevant from study of the Colombian experience alone.

A. The Conditioning System

1. Explicitness and specificity of conditions. Colombia is an example of highly specific loan conditions. This has meant that when performance is reviewed there is usually no question whether or not a given condition was met. This is no doubt a good thing. However, it leaves at least two major problems. One is maintaining the relevance of specific policy conditions. A target which was reasonable at one assumed level of coffee prices may become quite unreasonable if the price assumption turns out to be far off. The 1968 agreement tries to get around this problem by requiring additional liberalization or import registrations if coffee receipts exceed a specified amount. The other problem is that while performance on particular conditions is fairly unambiguous the weights that should be applied in reaching an overall summary judgement are by no means clear. In a Colombia-style agreement, featuring a large number of conditions, there is almost always at least one condition on which performance is demonstrably unsatisfactory. This means that there is almost always some weighting system which would produce an overall negative judgement. Generally, both sides agree on which are the major issues, but specificity on particular conditions does not guarantee this. It is sometimes argued that under the "LA system" everyone knows what the program is and just what has to be done to earn the next tranche, but this is not always so--witness the nonrelease of the fourth tranche of the FY 1967 loan early this year.

2. Enforcement. Does Colombian experience shed any light on the hypothesis that it is not the conditions themselves but the integrity with which they are enforced that really matters? Embassy/Mission leanings have usually been toward toleration and rationalization of Colombian performance. There has been no instance in which the field recommended withholding a tranche. The Washington attitude, originally also easy-going, hardened considerably during the period studied. Washington's stringent interpretation of performance conditions seems to have been an essential element in whatever policy influence A.I.D. has had in Colombia.

3. Number of conditions. It seems obvious to me that there is an optimal number of loan conditions and that the FY 1966 and 1967 loans exceeded it. A very large number of conditions strains staff capabilities on both sides, at both the negotiation and the review stages. It also compounds the ambiguity referred to earlier. It is doubtful that A.I.D. can use one loan to maintain credible leverage over more than a few conditions at any one time. The other items listed are there either for window dressing (the host government expects to do them

anyway and both sides agree that they will look good in the agreement) or for bluff (the aid agencies want something done but are not willing to spill blood to get it done). In the latter case, the real objective of the aid agencies may really be simply to legitimatize future discussion of an issue and keep the door open to the possibility that it can be sold to the host government through persuasion alone. This objective is a creditable one, but such conditions must be clearly distinguished from genuine fighting issues if we are to exert influence on the latter.

Another legitimate motive for large numbers of issues is the need to be comprehensive in some policy areas. For example, stabilization requires an integrated set of fiscal, monetary, and exchange rate policies if it is to be successful. The fact that in Colombia we were continuously interested in stabilization, among other things, required a certain multiplicity of conditions. But the number could have been much smaller than it was with no loss--almost certainly a gain--in influence.

4. Areas in which conditions were specified. In the last few years, as policy conditions were extended beyond the macroeconomic stabilization-cum-growth sphere into institutional and sectoral policies, there has been a discernible decline in the effectiveness of aid conditioning. The demands on the Mission staff arising from the need to formulate and later review policies for particular sectors and institutions proved too great to allow a careful job to be done in all areas. Even agriculture and education, the two sectors which were given most attention, received only a small share of the review time. Moreover, performance on policy conditions in these areas tended to be weak, in part, perhaps, becuase everyone understood that the ultimate sanction of withholding a tranche release would never be invoked because of nonperformance on these relatively minor conditions. This, however, is less a function of the area in which conditions are specified than of the large number of conditions specified and the fact that when there are many conditions some must inevitably be taken less seriously than others. I see no reason why the U.S. could not have made agricultural modernization, say, the most important set of conditions if it had chosen to do so (I am not saying we should have).

5. Dissipation through time. Colombia does lend some credence to the hypothesis that the political costs of exerting leverage can cumulate through time, making it increasingly difficult to obtain results in successive rounds of negotiation and review. Particularly in 1966 and 1967, A.I.D. tried to impose tough, specific conditions on the GOC. Despite considerable performance on the items specified, this attempt did lead to serious flare-ups and considerable hurt feelings --as well as noticeably greater difficulty in negotiating performance conditions in 1968.

There is no doubt that the aid agencies are now on the defensive in Colombia. There are fewer conditions in the current program loan and those that remain are less specific. Reviews are to be less frequent. In general, there is less consensus between the GOC and the agencies about what constitutes a desirable development program.

The criteria for fund release decisions are thus becoming more unilateral after two years of detailed bilateral agreement. This clearly constitutes a retreat from the idealized LA model of aid conditioning. It does not necessarily mean that program lending will lose its effectiveness as a tool for influencing policy, however, because this depends on how A.I.D. responds to any emergence of inadequate Colombian performance in the future.

B. The Loan

1. Loan size. The level of program lending to Colombia, on a twelve-month basis, has run at \$60 million in FYs 1963 and 1964, \$65 million in FY 1966, \$80 million in FY 1967, and \$78 million in FY 1968 (\$93 million if the sector loan is included). Nominally, the level was determined each year using balance of payments gap analysis. Actually, of course, a number of other factors were also influential, including Treasury and BOB reluctance to see U.S. assistance to Colombia rise. The only change in aid level that was related to performance conditions was the FY 1967 rise, which was intended to help finance a major program of import liberalization. As has been seen, the GOC not only responded but over-responded, thus helping to bring on the late-1966 foreign exchange crisis.

2. Trends in loan size. The loan level has been rising slowly in the past three years. These have been years of significant but uneven and interrupted progress. However, Colombian experience appears to tell us nothing about the relative efficacy of rising or falling aid levels for obtaining influence.

C. Environmental Influences

1. International politics. General diplomatic developments have had little impact on the U.S.-Colombian aid relationship. U.S. commercial interests have had an increasingly important negative influence, since the U.S. has increasingly sacrificed development objectives in Colombia for export additionality.

2. National politics. Colombia's unique political system makes the government in power more secure but also less powerful than governments in most LDCs. With its biennial elections to Congress and its guarantee of a new President every 4 years, it is also destructive of continuity. As in the U.S., there have been numerous cases in which the administration has been unable to get action it sincerely wants through Congress. The relative security of an administration for the duration of its term, on the other hand, may lessen its vulnerability to charges of having sold out to the North Americans (although the formula which allows most commitments to be made ostensibly to the IMF or IBRD no doubt helps reduce the pain for the GOC). The frequency of elections is particularly harmful. If elections are held every other year and distasteful decisions (e.g. on stabilization) are avoided during the year preceding an election, then tough measures are ruled out during half the time. The kind of determined, sustained multi-year effort that is needed to solve most development problems is exceedingly hard to get.

3. <u>Multilateralism</u>. As already noted, the U.S., the IMF, and the IBRD have had a close and fruitful partnership in Colombia. No doubt this partnership has been markedly more effective than a strictly bilateral operation would have been, especially in terms of ability to devise sensible policies and sell them to Colombians at minimum diplomatic cost. The muscle in the partnership has come mainly from A.I.D. and the IMF, while intellect has been provided by all three parties.

D. <u>Personal Touches</u>

Loan conditioning in the Colombian style makes enormous demands on the Mission Director and his staff. To do it well is even more demanding. Although some of the work can be shifted to the IBRD and IMF, an effective operation to influence policy on so broad a scale probably requires a strong Director and a full-time economic staff of perhaps four or five. A Mission with only one or two economists to work on program loan conditions would clearly have to employ a more modest system.

V. <u>CONCLUSIONS</u>

In summary, Colombia provides an example of a serious multilateral attempt to affect development policies, using A.I.D. program loans as a principal focus of influence. The conditioning system used started out loose, reached a high degree of tightness in FYs 1966 and 1967, and was partially relaxed in FY 1968. The effects of leverage on several important areas of policy are easily traced. Disturbing elements in the picture are (1) the frequency of crises, (2) an apparent tendency for resistance to aid conditioning in general to build up through time, and (3) the failure of Colombia, so far, to become an outstanding development performer, despite high aid levels and significant donor influence on policy. Obviously the real making or breaking of the influence exercise still lies in the future.

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INDIA

by

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PROGRAM LOAN STUDY: INDIA

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I. INTRODUCTION

Since 1962, the United States and other members of the India Consortium have increasingly emphasized non-project assistance. Coincident with this movement there has been growing pressure exerted on the GOI to institute reforms and change priorities -- to give primary attention to agriculture, liberalize imports, free up controls of the domestic economy, promote exports, encourage private foreign investment (particularly in the fertilizer industry), and promote family planning. This influence has been exerted both bilaterally and multilaterally with the IBRD as Chairman of the Consortium playing a pivotal role. Influence was relatively low key until about 1964-65. After the India-Pakistan war, far more pressure was exerted on the GOI to introduce new policy measures. At the same time, the war itself, two consecutive droughts and uncertainties about future aid, made it more obvious to the Indian government that its economic policies needed a significant change.

Program assistance has been the major portion of the A.I.D. program in recent years. It averaged about $225 million from 1961-62 to 1964-65 in terms of commitments to Indian fiscal years (IFY's) which are April to March. There was a low of $50 million in IFY 1965-66 following the India-Pakistan war. Commitments rose to $382 million in 1966-67 and amounted to $275 million in 1967-68 comprising more than 85% of total A.I.D. commitments. The level dropped to $217 million in IFY 1968-69. DL project assistance has steadily declined.

The U.S. has used program loans for bilateral leverage on Indian economic policies in an informal unstructured way. U.S. recommended policies or targets have not been linked up specifically to the loans as conditions precedent, except for some fertilizer matching requirements; and tranche releases have not been cycled to formal reviews or target achievements. Leverage has taken the form of a "continuing dialogue" with GOI officials; program loan releases have been related to performance implicitly, not explicity.

An important source of bilateral U.S. leverage, primarily on Indian agriculture policies and programs, has been the negotiation of PL-480 Title I sales agreements. PL-480 sales have consistently run at a level higher than the program loans, averaging over $230 million (country uses) between 1961 and 1964, and peaking at $548 million in 1966. Beginning in 1965 when a four-year PL-480 commitment expired, agreements were signed for only a one to three months supply of food grains, so that the U.S. could maintain a continuing watch on Indian agricultural policies. Leverage here has been more explicitly tied to the aid instrument, and often quantitative targets have been negotiated for e.g. tonnage of fertilizer to be distributed, acreage to be planted with new seed

* Research completed in February, 1969.

varieties, and land to be provided with minor irrigation facilities. In the agreements themselves, targets would be stated in terms of Indian self-help actions planned. Sometimes there would be more specific conditions contained in side letters or minutes. We have held up authorizations for PL-480 sales. This has induced the GOI to take actions it might not otherwise have taken.

Much of the conditioning of non-project assistance (excluding PL-480) from the U.S. and other Consortium members has come from the IBRD, both directly and through the Consortium. The U.S. has wanted the Bank to take the lead. In the spring of 1966, IBRD negotiations with the Indians were rigorous. There was particular emphasis on import liberalization, an area of primary U.S. concern, and agriculture. Other areas covered were export promotion, decontrol of industry, encouragement of private foreign investment and family planning. Some target dates were set for the coming year; others related to the end of the Fourth Five Year Plan (1971). Discussions were also held with the IMF at that time about the exchange rate -- devaluation was to be the basis for the top priority import liberalization program. After these discussions, and an Indian commitment to a new economic reform program, the Consortium members agreed to try to supply $900 million in non-project assistance which the Bank estimated was required for that fiscal year. The members further promised high levels in the future, contingent on the GOI's carrying through the program -- and to enable it to do so. The IBRD and the Consortium reviewed Indian execution of the policies discussed in the spring 1966 IBRD-India meetings over the next few years and made further commitments of non-project assistance on the basis of Indian progress and need. The U.S. did provide about 42% of this assistance each year; the percentage is less now. Since the U.S. has been the largest single donor, it has played an important role in determining the Indian policy changes which the IBRD would emphasize. It is impossible to distinguish clearly which Indian policies have been initiated by the GOI and which have resulted from U.S., Consortium or IBRD leverage. A slow process of persuasion has taken place, not leverage clearly linked to given loans or donors. The total volume of non-project assistance enabled the GOI to proceed with import liberalization and increase inputs into agriculture, two areas of primary concern to the aid donors.

II. CHRONOLOGICAL ACCOUNT OF INDIAN EXPERIENCE

Pre-FY 1962. India received non-project loans from the inception of the DLF in 1958. Individual loans ranged from $10 to $40 million, but there were frequently more than one signed during a year. There was a relatively large technical assistance program, averaging about $20 million per year, and a considerable amount of project aid. India also received a large amount of PL-480 assistance. Non-project loans were not conditioned in this period.

FY 1962. With the commencement of A.I.D. and the program loan concept in U.S. FY 1962, the level of program assistance was increased substantially. The higher level was to increase the utilization of existing Indian capacity. The first large program loan was signed in June 1962, following an earlier DLF non-project loan of $20 million. It was for $200 million, and fulfilled an earlier U.S. commitment of $220 million for IFY 1962-63 made at a May Consortium meeting. (The Consortium was formed in August 1958.) No reforms or other measures were linked with the loan. A loan paper discussed Indian self-help measures planned for the Third Five Year Plan period, April 1961 to March 1966. These included an increase in the role of investment as a proportion of national income, self-sufficiency in food grains, expansion of basic industries like steel, fuel and power, continued maintenance of reasonable price stability, increased taxation, and expanded employment. India, with five year development plans, an organized tax system, monetary controls, and land reform, was considered to be well ahead of most of the developing countries to which we were giving assistance. The loan was justified on the grounds that commodity assistance was necessary to supply equipment to maintain existing capital projects. Further, since India had a comprehensive economic plan, the commodities could be efficiently and rationally allocated. Through the Consortium, other donors committed about $210 million in non-project assistance that year; the total Consortium aid commitment was $1,295 million. There is no evidence that the Consortium at this time pressured the Indians into taking specific self-help measures to qualify for the assistance.

FY 1963. The $240 million program loan signed in February 1963 was part of a U.S. Consortium commitment for $265 million of non-project assistance -- the rest was supplied by an ExIm loan of August 1962. The total U.S. Consortium commitment was $435 million for IFY 1962-63. Other Consortium members contributed about $103 million of non-project assistance out of a total of $1,635 million.

Conditions were not attached to the U.S. program loan. We wanted to try to maintain the momentum of the Third Plan which had fallen behind schedule and had been further jeopardized by the October 1962 Chinese attack. A CASS written about the time the loan was signed stated we had initiated discussions with the GOI to indicate the types of changes in Indian policies that we and other donors felt were necessary to bring about the optimum use of aid, and that we would "urge the IBRD to play the leading role in providing continuing expert advice to the GOI in its analysis of its economic problems." Basic U.S. strategy was said to involve

> " . . . using our aid program to influence Indian policies and gearing the kinds and amounts of our aid to India's economic performance. The tendency of the Indians to call for more assistance to overcome their difficulties

should be countered by pressure from the U.S. and other friendly countries for improved performance by India itself. It is recognized that there will be limits set by Center-State relationships, political opposition, resistance to change, economic complexities, and the dangers of provoking charges of interference or other unfavorable reactions."

We stated we would point out in a general way what needed to be done. We did not propose to give the GOI detailed advice on all problems. We said at that time, however, that we would consider while developing a Long Range Assistance Strategy paper "whether it is necessary to require positive action toward changing Indian economic policy as a condition to our aid", and that "future PL-480 sales should be used as the occasion for negotiation of improved policies particularly for agricultural development".

FY 1964. In the fall of 1963 the GOI made a review of progress and shortcomings under the Plan. Notable shortcomings existed in agriculture. Irrigation, use of improved seeds, fertilizer consumption and plant protection were all far below forecasts. The cost of major public sector projects had increased substantially. Growth inhibiting controls over private investment, prices and imports were rampant. There were some bright aspects. Power, coal and transportation targets of the plan were exceeded; government revenues and the balance of payments had taken a turn for the better. The GOI was more determined to tackle administrative and management aspects of plan implementation and had set up study committees to see how this could be done. In December the GOI announced the termination of price controls on 16 items, and raised the ceiling on the size of firms which would be exempt from industrial licensing from $210,000 to $525,000 (at Rs 4.76 per $1).

A $225 million U.S. program loan was authorized in January and signed in February 1964 to assist the GOI in the Third Year of the Plan. It was part of a Consortium commitment of $499 million in non-project assistance. The total Consortium commitment for that year was $1,052 million. The loan paper for the $225 million loan summarized the U.S. position on conditioning as of that time. It stated:

"During the last year there has been some widening and opening up of the avenues of discussion with the Government of India on questions of economic policy. This has not waited for the negotiation of the program loan. The determination of the total annual aid level, preparations for the meetings of the Consortium of donors, the continuing administration of U.S. aid -- commodity, project and food financing -- and the military program, all afford suitable occasions for the repeated expression of U.S. concerns in an exchange of views about economic policy from its broadest reach to any degree of refinement the Country Team and A.I.D. think useful. The Government of India, while reserving the right of decision to itself, has proved open to sound and well-documented argument even in areas that touch the heart of policy."

The paper further stated:

> ". . . we do not think that attachment of specific conditions in the form of targets of achievement, changes in policy, or shifts in emphasis or practice would accelerate or sharpen present consideration within the Government of India and we do not suggest any be specified in relation to the program loan."

This answered the question posed the preceding year. We would not specifically condition our loans, but would use the "continuing dialogue" approach. The loan paper gave examples of it. In November 1963, Ambassador Bowles wrote a letter to the Finance Minister suggesting a careful review of price control policies and mechanisms which were inhibiting production. (This was the beginning of pressure for liberalization. The Consortium was brought in as an ally about this point.) He also identified the private sector as a source of additional capital and management resources and made a number of suggestions for encouraging the flow of private resources. The Ambassador discussed the significance of an intensified effort in agriculture in another letter to the Prime Minister. The loan paper stated that these and other initiatives were one element in an extensive pattern of relations "without specific reference to U.S. assistance, the timing of actions under present commitments or prospects for the next Consortium."

In the spring of 1964 A.I.D. requested $50 million for an initial non-project commitment toward the fourth year of India's plan. The loan paper repeated the statement about "the widening and opening up of the avenues of discussion with the GOI on questions of economic policy . . . not . . . related to the negotiation of particular loans or aid transactions". It further stated that "certainly the discussions and negotiations regarding the large dollar commodity program assistance loans form an important element in this overall pattern." The paper concluded again that we did not wish to attach specific conditions to our loans. Our concern was to "sustain and deepen the substantive discussion." The loan was authorized in April and signed in November 1964. Meanwhile, Indian committees had continued to study the control systems of the economy, and in March 1964, decontrol of all non-flat steel products was announced. A.I.D. considered the steps which had been taken in the preceding six months as falling well short of what was desired, but they were steps in a new direction, the first moves away from the increasing controls of recent years.

FY 1965. At a meeting of the IBRD-led Consortium in May 1964, the U.S. indicated it was prepared to provide about $275 million of its total pledge of $435 million for IFY 1964-65 in the form of commodity loans. At the same time the U.S. indicated to the GOI that $225 million would be provided under conditions similar to those of preceding years, and that up to $100 million in additional commodity loans, for a potential maximum of $325 million, could be provided to assist the GOI in making certain policy adjustments. The additional funds could help accelerate and broaden the range of decontrol measures that might be undertaken and facilitate the import of additional inputs for agriculture such as fertilizer. The specific terms of the "add-on" were as follows: (a) An additional dollar of non-project aid would be provided for every dollar equivalent of additional fertilizer the Indians imported from free world sources above an agreed base. We expected that increased fertilizer imports could become necessary following fertilizer price reduction or improved distribution or both. (b) An additional dollar of non-project aid would be provided for every additional dollar equivalent of licensed imports of raw materials or commodities shown to be required to meet shortages that had resulted in under-utilization of plant capacity (over an agreed base) in high-priority sectors, if appropriate price adjustments were made where needed. (c) An additional dollar of non-project aid would be provided for each dollar equivalent of additional imports when imports of a commodity rose (above an agreed base) as a result of relaxation or elimination of controls, provided that A.I.D. was satisfied that price policy for the imports was appropriate.

As of February 1965, the GOI had not experimented further with decontrol. A sharp rise in food prices and a general increase in the overall price level had created an unfavorable climate for the introduction of decontrol measures. Further, the new Shastri government was in the process of consolidating its position and did not appear ready for radical new measures. The prospects for additional lending under (b) and (c) above did not appear likely. However, the GOI had moved to expand the import of fertilizer and cut back fertilizer prices. The use of additional commodity loan funds for fertilizer over and above the base was expected. The loan was thus for $190 million, including $150 million to make up the

$225 million Consortium pledge ($50 million from A.I.D. and $25 million from the ExIm had already been provided), plus an additional $40 million to match GOI additional fertilizer procurement. The loan for this amount was signed in June 1965. The leverage on Indian policy attempted through the "add on", a carrot as opposed to a stick, had thus worked partially. This was the first specific attempt we made to improve Indian performance through manipulation of A.I.D. funds.

Meanwhile, in the Consortium meeting of April 1965, on instructions from the U.S. President, A.I.D. for the first time made a "soft" pledge of dollar assistance for IFY 1965-66 rather than a firm one. A.I.D. referred to a number of reservations about Indian policy and performance, and said the availability of aid would depend on Indian progress on economic reforms. We listed these reforms in detail at the Consortium meeting. A two-year IBRD-financed study directed by Bernard Bell, with substantial A.I.D. staff collaboration, had convinced all the Consortium members that Indian economic reform in many areas was urgently required. We also had become convinced that assistance needed to be more closely linked with Indian self-help. The prior pattern had been general endorsement of the magnitude of needs for a full Five Year Plan period, a firm public pledge each year of a dollar aid amount, and a four year PL-480 agreement.

<u>FY 1966</u>. The CASS written in July 1965 proposed that the U.S. condition assistance toward India's Fourth Five Year Plan, which was to begin in April 1966, on progress in the following Indian policy areas: de facto exchange rate adjustment, liberalization of non-project imports, export expansion, encouragement of foreign private investment, family planning, agricultural development and fertilizer production, rural manpower and construction programs and the general quality of decision-making and administration. The CASS stated we would use all our assistance instruments to this end, but particularly the program loan which would help implement the policy changes. We would let IBRD and the IMF bear the brunt of the negotiations. The CASS also said: "there is a narrow limit to the extent this approach can be followed in practice but it is important that we keep appearances this way."

Changes had begun to take place in Indian agriculture. India's first program of incentive price supports (not too meaningful as market prices were high) had been introduced; efforts were being made to step up the supply and application of fertilizer, water and improved seeds. However, the USDA and others had undertaken studies which concluded we had to push the Indians much further. In July a four year PL-480 commitment expired, and at the same time Agriculture Secretary Freeman visited India. Instead of negotiating a new long-term agreement, we signed an interim agreement which provided for less than a two months' supply of foodgrains.

Thereafter PL-480 agreements were to provide no more than a three months' supply of foodgrains until a half-year supply offer was made in late 1967. This was done so we could exert leverage frequently on Indian agricultural policies and programs. Previously, we had reviewed Indian agriculture every year, made excuses about the lack of Indian performance and released the foodgrains anyway. By making a four-year commitment, we had essentially foreclosed future leverage.

A.I.D. commitments were held back pending passage of the FY 1966 FAA. We were thinking in terms of $250 million in program assistance for the last year of the Third Plan if Indian performance improved. When the Indo-Pak war broke out on September 5, 1965, all new assistance commitments to both countries were suspended. The Indians were informed in mid-September that aid was to be frozen until a valid cease-fire was achieved.

After the cease-fire, we negotiated another small PL-480 agreement (September 29th) providing for less than a month's supply of food grains. In November 1965, Secretary Freeman, spurred by the U.S. President and Congress, met with Minister of Food and Agriculture Subramaniam in Rome, and an agreement on Indian agricultural policies was negotiated. Investment in agriculture in the Fourth Plan was to be more than doubled; during 1966-67 alone it would be increased by at least 40% even though the emergency, caused by the war combined with a drought, might require cutbacks in other areas of investment. High annual fertilizer consumption targets would be met by both higher domestic production and higher imports; imports would make up for shortfalls in domestic production. Basic policy changes encouraging foreign private investment in the manufacture and distribution of fertilizer were to be implemented. A fertilizer marketing plan was to be announced by January 6, 1966. Steps would be taken by the GOI to operate its own fertilizer plants at full capacity by allocating enough foreign exchange to ensure adequate supplies of raw materials and spare parts and by carefully reviewing management effectiveness periodically. Specific actions would be taken to improve the existing system of credit cooperatives. "Packages" of agricultural inputs -- fertilizer, improved seeds, pesticides, water -- would be made available to 32 million acres of the most productive land farmed by the more efficient farmers. On this selected acreage a target was set of 25 million tons of additional food grains by 1970. It was agreed that price policies would be reviewed periodically to ensure a continuing favorable relationship between the price of food grains and the price of purchased inputs such as fertilizer. The Center government was to develop a rational food policy and use its power to regulate distribution between states. The highest priority would be given publicly to agriculture; agriculture would also receive priority in the allocation of foreign exchange. Finally the agreement specified a food aid phase-out schedule. This agreement is sometimes called the "Rome Treaty".

Minister Subramaniam returned to India and presented this program to the Indian cabinet as a GOI program. The U.S. was substantially supporting policies Subramaniam already favored, but he needed the financial and political support of the rest of the GOI. The program was also presented to the Parliament in December. A few days later another short-term PL-480 agreement was signed. The presentation to Parliament became the loan paper for the first program loan to be negotiated after the war, a $50 million loan exclusively for fertilizer imports signed January 4, 1966. This was to be the only program loan committed to IFY 1965-66. A condition of the loan was that India match the 200,000 tons of nitrogen fertilizers to be financed by the loan with an allocation from non-A.I.D. resources to import at least an additional 300,000 tons plus necessary amounts of related fertilizers and sulphur. The fertilizer would be applied to the crop beginning in the spring of 1966. Prior to authorizing the loan we also obtained specific agreement on how India would encourage private foreign investors in the fertilizer industry, including concessions on equity participation and on private marketing free of price and zone limitations. The GOI announced these concessions in December. Prior to signing the loan, A.I.D. consulted with appropriate members of Congress in accordance with Secretary Rusk's commitment to Congressman Mahon in September that the "Executive Branch would consult with appropriate members of the Congress on the situation in the sub-continent in connection with making new economic aid loans or grants". A.I.D. further stated in the PAAD to the loan that "prior to conclusion of the loan, arrangements will be made for further review of Indian policies and for the establishment of target dates for needed policy changes and administrative improvements." There is no available evidence that more than the above was done.

The Tashkent Declaration was signed on January 10, 1966. Vice President Humphrey informed the Indians at the time of his visit in February that we would provide a $100 million program loan as an interim action to allow further consideration of the policy issues involved in the preparation of the delayed Fourth Five Year Plan. The Indians were in great need of additional foreign exchange resources, we said, and progress had been made in carrying out the Tashkent Declaration. Military forces were being successfully disengaged and political tensions were lessening. A condition of the loan, though not written into the agreement per se, was that the GOI allocate foreign exchange from other resources for the same purposes as the loan -- to increase the use of existing capacity, and obtain fertilizer and other high priority inputs for agriculture. The request to the President stated that another condition in the negotiations would be that highest priority be given to economic development; funds would not be sacrificed to an arms race. These conditions plus the provision that the funds be used for existing capacity as opposed to building new capacity or increasing reserves, applied also to a $50 million loan to Pakistan. In addition, we would insist that the Indians provide "a clear indication of intent to resume their interrupted dialogue with the World Bank on major policy issues in connection with improved development plans". The Consortium meeting had been postponed when the war began. It was stated agai. that "prior to disbursement under the loan, arrangements will be made to assure effective monitoring of the execution by the GOI of relevant policy changes and improvements." This probably had to do with the GOI's matching of imports for underutilized capacity and for agriculture. The nature of the arrangements is not in the record. The loan was authorized on March 28th and signed on May 13, 1966. It was committed to IFY 1966-67, the first year of the yet-to-be finalized Fourth Plan. We felt that though this loan would ease India's economic pinch, we still had ample bargaining power left.

The new Prime Minister, Indira Gandhi, visited the U.S. in March. No further aid commitments were made at this time. The $100 million loan had been announced in February, and Mrs. Gandhi did not wish to appear to be begging for more aid. Further, the U.S. wanted more concrete changes in Indian policies. A month after Mrs. Gandhi's trip, the Indian Minister of Planning, Asoka Mehta, held meetings in Washington with World Bank President George Woods and IMF representatives. Mehta went to these April-May meetings with considerable flexibility to negotiate new GOI policy measures. The negotiations were forceful, and the minutes of these meetings provid- the basis for India's new economic reform program. The main emphasis o. the Woods-Mehta meetings (some call them a "confrontation") was on import liberalization, though other areas such as agriculture, family planning, export promotion and private foreign investment were also covered. Devaluation, required before imports could be liberalized, was discussed with the IMF. These discussions had strong U.S. support and encouragement. We were letting the IBRD bear the brunt of the conditioning, except for agricultural policies, though we collaborated closely with the Bank. In fact the IBRD did not go as far as we wanted on import liberalization e.g., it let the Indians keep the licensing system on liberalized imports. The GOI could later use the licensing system instead of resorting to fiscal poli.y. However, we felt we had to accept the package and not reopen the discussions.

These negotiations and India's new economic reform program, provided the basis for a higher level of Consortium non-project assistance commitments. The higher level of $900 million recommended by the Bank and accepted by the Consortium in its May meeting was conditioned on India's execution of the policies to which it had committed itself. The $900 million would assist the program and make it possible -- both the liberalization of imports and accelerated agricultural development required increased imports. The Consortium also expected India to carry out other policy changes which did not directly require imports.

The U.S. and the IBRD with considerable effort had convinced other donors to more than double their non-project lending -- while the U.S. commitment increased by about 50%. The total Consortium non-project commitment was $400-450 million higher than in the years preceding.

The GOI formally devalued the rupee by 36.5% de jure on June 6, 1966. The devaluation was probably the most politically difficult element of the reform package. A few days after it took place, A.I.D. requested authorization for a $150 million program loan out of FY 1966 funds. The loan was signed on July 8th. By that time a 10% surcharge had been eliminated. There had been no liberalization of imports as yet, but the GOI announced the prospect of a liberalization program on June 21st. Industrial license requirements were removed from 11 industries on July 4th -- the GOI had taken earlier steps toward decontrol of industry in May. We noted that private foreign capital investment was being encouraged in fertilizer, chemicals and other needed fields, and we said the GOI was taking forceful actions to assure the availability of capital inputs and raw materials required to step up food production.

We signed the $150 million loan about a month after the devaluation. We signed it to encourage the GOI to carry through with import liberalization and as a reward for devaluation. British and Canadian commitments also came through quite early. The Germans did not release funds till about December but then they released all funds for the year at once. What was considered the first phase of the liberalization plan was announced in August. It was formally rather different from that outlined in the Woods-Mehta minutes but constituted an effective first step. Fifty-nine priority industries (we had expected liberalization by commodity) which accounted for about 75% of industrial production, were given special treatment which in effect allowed them to import as much raw materials and spare parts as they needed. The structure of the previous system of administrative controls over import licensing was maintained even for these industries, but licenses were to be granted with a minimum of review. Further, firms granted import licenses were allowed greater flexibility in the use of these licenses. Six raw materials for very high priority export industries were placed on Open General License with no restrictions on the quantities imported and with access to free foreign exchange. Also items were deleted from the list of domestically manufactured goods which could not be imported. Further, public sectors industries were required now to go through the same procedures as private sector industries. Previously, public sector industries had easier access to imports.

FY 1967. The next program loan, for $132 million, was not signed until May 1967 though it was part of the U.S. share of $900 million in Consortium assistance pledged to IFY 1966-67. Part of the delay had to do with lack of progress on the Tashkent Declaration. The delay also applied to a $70 million tranche for Pakistan. However, we did tell the GOI earlier it could probably count on this tranche. We felt that India had been taking steps in the right direction. In January 1967, 33 more industries had been added to the decontrolled list. India had dramatically changed course in agriculture for the better -- in policy, administrative drive and budgetary priority. We wanted the GOI to take further steps toward the liberalization of imports, but measures already taken could not be tested. The recession caused by two consecutive droughts had reduced import demand.

The program assistance paper stated that the proposed loan did not provide the U.S. government with further leverage to bring about additional Government policy decisions since it was part of the Consortium package for IFY 1966-67 designed to finance policy steps already undertaken. We said that by completing the $900 million Consortium package we would ensure continued effective implementation of the import liberalization program and lay the basis for discussion with the GOI on further steps in liberalizing imports next year. We said we would discuss all important policies with the GOI including the accelerated agricultural development program, but would focus on two areas -- future of import liberalization and fiscal policies -- because of their importance and likely Consortium follow-up. While we would let the IMF mission take the lead in expressing concern about inflationary pressures, we would support their presentations and closely follow the formulation of the 1967-68 budget.

The Consortium had met again in April 1967. The members agreed with an IBRD assessment that Indian self-help progress had been substantial. Further progress was desired in the import liberalization program, export expansion, private investment incentives, and family planning. The Bank assessed an Indian need of another $900 million in non-project imports for IFY 1967-1968 for the continuation of the reform program, plus another $190 million from the Consortium to match a U.S. food offer. The actual Consortium pledging session was not held until November, because it was important to give an early emphasis to food assistance matching and debt relief.

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In May, after the Consortium fulfilled its IFY 1966-67 pledge and agreed that $900 million should be provided in IFY 1967-68, the GOI announced additional import liberalization steps. The liberalization of maintenance imports for the 59 priority industries was continued and improved in some details. Small units in priority industries were given the same facilities as large scale units. They, too, would get as much as they needed for production. Certain aid-financed spare parts were completely freed of controls, and export industries were to be given freedom in choosing sources of supply. Greater flexibility was given to commercial importers. On the negative side, the list of banned imports was expanded.

The U.S. in FY 1967 had exerted considerable bilateral leverage on Indian agriculture policies through negotiation of PL-480 agreements. In the negotiations preceding the February 20, 1967 agreement, targets for IFY 1967-68 were worked out on imports and domestic production of fertilizer, additional planting under new seed varieties, and number of acres to be covered by minor irrigation and plant protection. Agricultural credit, rural electrification, training programs for farmers, supply of agricultural machinery and agricultural research would be stepped up, and specific targets were set for the next two fiscal years. The agreement also stated that there would be a timely announcement of food grain support prices. Separate minutes of understanding were signed outside the agreement. The GOI publicly announced this program in advance of signing the new PL-480 agreement to be in a strong position to maintain that the specific self-help provisions which appeared in the agreement merely reflected its own decisions. Probably many of them did. It is difficult to distinguish U.S.-imposed targets from Indian targets. The PL-480 agreements, however, made the Indian Plan commitments firmer than they would otherwise have been.

Another PL-480 agreement signed in June 1967, provided that India would move more heavily into the production of food crops as compared with non-food crops in world surplus. FY 1971 acreage targets were set for food crops. The agreement also included statements on family planning, reduction of duties on imported equipment used in fertilizer plants, efforts to find domestic phosphate rock, and effective nationwide planning to reduce food grain losses.

FY 1968. The next non-project loan, for $50 million, was authorized in June 1967 out of FY 67 funds, and signed in October. It was the first tranche of non-project assistance for IFY 1967-68 and was to help India continue the economic reform program which commenced in 1966. The loan paper stated that while no specific GOI policies would be uniquely linked to the loan, we expected to emphasize import liberalization, added steps where possible toward further relaxation of administrative controls over industry, and continued efforts to increase agricultural production, particularly maintenance of the fertilizer import targets previously agreed to in PL-480 negotiations.

At the November Consortium meeting the donors accepted an estimate of $750 million, as opposed to the earlier estimate of $900 million, in non-project assistance as the requirement for IFY 1967-68. The Indian recession had reduced demand for imports. But without an IDA replenishment, India would probably obtain only $543 million. Other donors would contribute the same amount as the preceding year. The Consortium in its review of Indian policies and programs emphasized agriculture, family planning, exports and defense expenditures.

A third supplement to the February 1967 PL-480 agreement (a second in September reaffirmed earlier self-help provisions) was signed on December 30, 1967. There had been a long delay over negotiation of policies and targets. Secretary Freeman went to India again during the negotiations. The self-help measures negotiated were listed in the agreement. They include maintenance of government procurement price levels even if procurement targets were exceeded, and creation of buffer stocks as quickly as conditions would allow. The hoped for buffer stock target was 3.5 million tons by the fall of 1968. Targets for fertilizer availability, acreage to be planted under new seeds, crop protection and irrigation during IFY 1968-69 were set down. The U.S. after much effort was unable to obtain an Indian commitment to abolish food zones, or on specific targets for buffer stocks. We did refuse to accept India's proposal to reduce its fertilizer consumption target from 2.8 to 2.5 million tons for IFY 1968-69; and India did make a first step toward liberalization of food zones in late March, 1968.

In March, the Mission submitted a request for $225 million to raise U.S. program aid to India in IFY 1967-68 to $295 million, including an Export-Import Bank loan of $20 million. The U.S. contribution was over $100 million lower than in the past year while other donor contributions, except for the Italian, remained the same or slightly higher.

The $225 U.S. million program loan was not conditioned on specific self-help actions, but the Indians were expected to continue along the lines of the 1966 Woods-Mehta agreement. No further steps had been taken toward import liberalization, but neither the U.S. not the IBRD faulted India, particularly as there had been a slow down in Consortium pledges of assistance. The loan was signed in May 1968 to be applied to the IFY which had ended March 31. It would finance imports in that year retroactively.

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The India Consortium met in May 1968. The major concern of the members was poor Indian export performance. Many countries including the U.S. could not make pledges at that time. The IBRD estimated that India required about $950 million of Consortium assistance during IFY 1968-69. The first $100 million was met through successful conclusion of debt relief negotiations.

FY 1969. A $23 million U.S. loan for fertilizer and fertilizer mixtures was authorized in June 1968 and signed in July. Another $194 million loan was approved in November and signed in December. It included an earlier request for $50 million for fertilizer which had not been approved by the President in order to leave options open to his successor. The $194 million loan brought A.I.D. non-project loan commitments to $217 million for IFY 1968-1969, the lowest level, aside from the war year, since the beginning of A.I.D. program lending.

Another PL-480 agreement was negotiated in the fall of 1968. The self-help provisions were to include additional storage facilities, incentive prices, and the strengthening of irrigation, agricultural research and farmer credit.

Thus far the GOI had maintained the liberalization program despite (a) the total unavailability of IDA funds in 1968, (b) the fact that the bulk of the U.S. portion of assistance for IFY 1967-1968 was not made available until after the close of that year, and (c) contraction in the assistance pipeline. The Consortium-recommended $950 million of non-project assistance for IFY 1968-1969 was unlikely to be forthcoming. We now hoped India would maintain its import liberalization program and high fertilizer imports. We did not expect further liberalization at a time of lower assistance levels and an uncertain future.

III. THE PRINCIPAL ISSUES

A. Did A.I.D. Try to Exert Leverage with the Program Loan ?

A.I.D. did try to exert leverage with the program loan, although A.I.D. did not usually choose to have specific self-help conditions included in program loan agreements. We would often wait until the GOI had taken action before signing a loan agreement. For instance, the GOI made a firm commitment to encourage foreign private investment in fertilizer plants before the $50 million fertilizer loan of January 1966 was signed. India devalued in June 1966, before a $150 million program loan was signed. Signing the loan agreement would then be a reward for past performance, less a commitment for future action. The U. S. also tried to obtain leverage on Indian performance by pledging an overall amount of program loan funds to each Indian fiscal year, and maintaining a "continuing dialogue" with GOI officials. Further, total Consortium offers of non-project assistance were intended to provide leverage. The GOI expected Consortium non-project assistance to average at least $900 million annually, beginning in 1966. Actually, it has averaged much less.

The IBRD took the lead in recommending Indian policy changes and targets. Before Consortium non-project assistance was committed for the next Indian fiscal year, the Consortium would evaluate Indian achievements and commitments for future action. Indian shortcomings would be discussed with GOI officials at the Consortium meetings, and policies would be recommended. Proposed action or targets were not, however, linked to specific loans.

The U. S. did try to tie leverage on future policies more closely to an aid instrument in PL-480 negotiations from late 1965 on. Annual quantitative targets such as for fertilizer distribution, and acres to be planted under new seed varieties or to be sprayed with pesticides were agreed on, as well as qualitative targets such as commitments to build Central Government buffer stocks or maintain incentive food grain procurement prices. Sometimes these commitments would be listed in a PL-480 agreement under Indian self-help actions planned. There were in some instances minutes of understanding outside the agreement, setting down agreed policies and targets.

B. Did India Perform?

Indian self-help performance since 1965-66, when the new economic reform program was introduced, has been mixed, but performance has been more good than bad. There has been a significant reorientation toward emphasis on agriculture and away from extensive controls over the economy. Less than satisfactory performance in some areas can be explained by the two consecutive and serious droughts of 1965-66 which brought on industrial recession. Further, India has received less non-project assistance than anticipated, and future aid levels are uncertain.

GOI officials have been less than convinced that some U.S. and Consortium recommendations are worth carrying out for ideological or other reasons. This is true of extensive decontrol of industrial production and strong encouragement of private foreign investment where there have been powerful ideological constraints. India has preferred to concentrate on import substitution as opposed to export promotion. Abolition of food zones was difficult in a period of scarcity, and the problem was aggravated by the political relationships among the states and between the Center and State Governments. Import liberalization and decontrol of the domestic industrial structure have not proceeded as much as we would have liked. Initial steps were taken in both these areas but the further steps expected were not.

India has been very successful in other areas, often going beyond targets set, e.g. on fertilizer imports. The transformation of Indian agriculture -- IFY 1967-1968 was a record crop year -- has been almost phenomenal. The distribution of large quantities of fertilizer to Indian farmers, for which the U.S. exerted considerable leverage and provided a good part of the financing, has been important for this success -- so has the new emphasis on support prices, new seed varieties, plant protection and irrigation. Another program which has made considerable headway is the family planning program assisted by the U.S. and other donors.

India has definitely performed better since increased pressure was put on the GOI starting after the 1965 India-Pakistan war. Part of this improvement is due to increased U.S. and Consortium leverage, and part to the fact that the Indians became convinced that the reforms were necessary. The two years of drought served to convince them that agricultural production must be given top priority, and after the war they were convinced that they were too dependent on outside assistance. Higher commitments of non-project aid did enable the Indians to devalue, to carry out some measures to decontrol, and to push agricultural development.

C. Did A.I.D. obtain leverage?

A.I.D. did obtain leverage though it is sometimes difficult to attribute specific self-help performance to the leverage of either the U.S., other members of the Consortium, or the IBRD, from what the Indians would have done anyway. The leverage process was one of gradual persuasion over a period of time. The Indians would eventually become convinced that policies the donors advocated were in their own interest, and would present them as Indian policies which were usually untied to specific program assistance agreements. However, A.I.D. often waited for the GOI to take specific action before signing a loan agreement. As indicated in section B, we and the other donors have not been successful in getting the Indians to adopt all the policies we have advocated, but we have made great progress.

D. Can A.I.D. Leverage be Attributed Specifically to the Program Loan?

A.I.D. leverage can be attributed to the program loans as they have constituted most of A.I.D. assistance during the time we tried to exert leverage. Leverage has been applied during program loan negotiations, but also throughout the year in a "continuing dialogue" with GOI officials which has been informal for the most part. We could probably not have obtained the leverage without the program loan, even if our total assistance level had been as high. The program loan financed the Indian economic reform program the way project assistance could not. Further, as one A.I.D. official said, program assistance is desired about six times as much as project assistance. Project assistance is more easily obtained elsewhere, and project funds do not move as quickly. Of course A.I.D. has obtained leverage from project assistance too, for instance on the family planning program, fertilizer marketing, and the dissemination of improved seeds. Further, as mentioned previously, PL-480 negotiations proved to be an important source of leverage on Indian agriculture programs.

IV. DETERMINANTS OF LEVERAGE

A. The Conditioning System

1. Specificity of Conditions

Some of the agreed targets were specific e.g., fertilizer availability and acres to be planted under new seeds in a given Indian fiscal year, or by the end of the Fourth Five Year Plan. These targets were agreed on in World Bank-GOI meetings (particularly the Woods-Mehta meetings of 1966), and in U.S. negotiations of PL-480 agreements. The targets were not tied to specific program loan agreements which were not cycled to the end of an Indian fiscal year. Some of the specific targets were not necessarily U.S. or Consortium imposed conditions but Indian Plan targets. The donors might have influenced the GOI to set plan targets of a certain magnitude, but the targets had usually become accepted by the Indians by the time an agreement was negotiated. Other conditions, such as encouragement of private foreign investment, were not specific and lacked definite time limits, although the GOI was aware of what the donors had in mind.

2. Number of Conditions

The U.S. and the Consortium usually emphasized only a few areas at once though many areas would be discussed. Starting in 1966 the two areas of emphasis were import liberalization and agriculture. More recently we have put more emphasis on export promotion. Most experts connected with the India program are convinced that you can only push one or two areas at one time, especially when a few GOI officials may have to persuade a large number of others to accept new policies.

3. Policy Areas in Which Exerted

Partly because of the types of policies we have tried to influence, quantitative conditioning, target dates, etc. make less sense than for instance in monitoring stabilization indicators such as money supply, where more constant surveillance is necessary. The changes we pursued in India required pressure over a long period of time. We were seeking broad policy moves in the "right direction" over a period of years. The Woods-Mehta negotiations were to influence the period of the whole fourth Five-Year Plan, 1966-71. This is perhaps not the whole answer to the relative lack of quantitative conditioning in India. India's strong political sensitivity to outside pressure and our resultant inability (or unwillingness) to set quantitative or even qualitative targets associated with more formal reviews and subsequent tranche releases are important. Indian desires for neutrality and acceptance of aid from both East and West must be considered. As far as Indian sensitivity and fear of political and public opposition are concerned, a tighter conditioning system would need not be made public. However, there would be grave dangers of public disclosure of such a system.

4. Rigor of Condition Enforcement

Negotiation and authorization of program loans were not explicitly linked to Indian performance. Once loans were authorized and signed, there were no conditioned tranche releases or threats of withholding or deobligating funds if Indian performance were subsequently unsatisfactory. There was the implicit/unwritten threat of delays or reductions in size when new loan negotiations would be undertaken. Separate loans were called "tranches" of an IFY commitment, but they were not tranches in the LA sense.

5. Dissipation Through Time

Leverage has dissipated now because the Indians have become hesitant to initiate policy changes and then not receive program loan funds at the time and in the amount expected. Both the Indians and members of the Mission staff were saying in 1968-69 that we can expect to obtain little leverage now that our assistance has dropped and future levels are uncertain. A top Indian official said in the summer of 1968 that the GOI would no longer subscribe to "forward conditioning." We said in response we have never required "forward conditioning" but have based our assistance on past performance.

B. The Loan

1. Size of the Loan

The program loan has completely dominated A.I.D. assistance particularly since 1966. The loans have been highest of any recipient in absolute terms, but lowest per capita. Program loans have averaged less than 10% of Indian imports -- about average for the major program loan recipients. Both total U.S. (including PL-480) and total multilateral aid to India have been highest of any recipient both in absolute terms and in terms of Indian imports; total aid has been lowest per capita.

2. Direction of Change in Loan Size

The U.S. level changed from an average of about $230 million prior to the 1965 war, to a low of $50 million in 1965-66 (in terms of commitments to Indian fiscal years), and then to a high of $382 million during the first year of India's economic reform program, and $275 million the next year. In 1969 it dropped to $217 million. The increase in size in 1966-67 brought improved Indian performance. As indicated earlier, greater U.S. non-project assistance (along with the larger commitments from the other Consortium members) helped India carry out import liberalization and give a new emphasis to agriculture. The low level of 1965-66 helped encourage the Indian economic reform program. We were in a good position to exert leverage after cutting off aid during the war. The Indians then realized we could mean business. The low in 1965-66 was definitely designed to increase leverage for economic reform and for reduction of military expenditures, elimination of hostilities, and negotiation with Pakistan. The lower level to which program loans have fallen in the last two years, however, is decreasing our leverage, as mentioned earlier. The recent fall in size can be attributed to lower FAA appropriations rather than to an effort to extract better performance out of the Indians. The lower level limits the GOI's willingness to plan ahead, particularly to commit itself to further import liberalization, and it may result in retrenchment on some measures already taken.

C. Environmental Factors

1. Multilateralism

Multilateral leverage has played a very important role in India. The India Consortium has existed since August 1958 and has held regular meetings since then, usually more than once a year. The World Bank, as Chairman of the Consortium, prepares a thorough study of the Indian economy and members of the Consortium, while considering India's requirements for external assistance, discuss Indian economic policies and suggest reform measures. The World Bank, both in its role as Chairman and as an international lending agency, recommends policy and program reforms to the GOI in the Consortium context and bilaterally. Probably the most significant single instance of leverage exerted by the Bank was the Woods-Mehta series of discussions in the spring of 1966 which established the new economic reform program on which further Consortium non-project assistance was to be based. Here specific targets and policies were negotiated and set down, both for the following year and for the fourth Five Year Plan as a whole.

A sketch of Consortium and IBRD efforts to exert leverage runs as follows: As early as 1963, the Consortium urged the GOI to operate its controls more flexibly, and in fact, some early progress was made. In 1964 the Consortium Chairman's report noted that further Indian efforts were needed in the areas of agricultural development, family planning, export promotion and additional encouragement of foreign private enterprise. In March 1965, the Consortium expressed doubts about the adequacy of Indian reform measures taken to date and noted that problems still existed in the areas of agricultural growth, industrial capacity utilization, population growth, exports and private foreign investment. In addition, the extent of government controls over industry and imports was decried. Many of these criticisms resulted from a two year intensive study undertaken by Bernard Bell financed by the Bank but with substantial collaboration of A.I.D. economists.

As the Bell study gradually exposed Indian planning inadequacies, both the U.S. and other donors shifted from a position of accepting Indian policies as more or less adequate, to one of vigorously pushing Indian reform. The issues raised in the Bell report were discussed at all Consortium meetings as well as bilaterally by the Bank.

The Indians did not make significant policy changes until 1966 when the Woods-Mehta confrontation took place. This confrontation, and the specific reform plan negotiated was a culmination of a few years of pressure primarily by the U.S. and the Bank, but by the Consortium as a whole as well. It was an important turning point. The aid donors in the years following the confrontation have made a concerted effort to keep the Indian economic reform program going in the right direction. In this effort they have succeeded quite well.

The IMF has also played a leverage role in India. It has established three Stand-by agreements with India since 1963 and has suggested reforms primarily in fiscal, monetary, and exchange policies. Further, the IMF has exerted influence as part of its Article XIV reviews and in response to India's request for tranche releases. At the time of the spring 1966 Bank-GOI meetings, the IMF worked with the GOI on the devaluation which took place in June 1966. The U.S. supported the IMF's moves. We were clearly in favor of the devaluation which was not something the U.S. could push bilaterally. It is unclear how much pressure the U.S. put on the IMF to encourage Indian devaluation. The leverage web in India is tangled. Separate identification of leverage with any one donor is difficult. The whole was more than its parts. The U.S. had important influence as the largest aid donor, and we had much to do with determining the areas in which the Bank, Consortium and IMF exerted leverage.

2. International Politics

India has tried to maintain neutrality between East and West. The USSR and other bloc countries have had a substantial aid program in India which had cumulated to about $1.9 billion through CY 1967. The GOI is somewhat able to play off the East against the West. Each block wishes to have an influence in India and does not want India too dependent on the other.

3. Domestic Politics

Obvious U.S. or other donor pressure on the GOI would cause it great problems politically, not just with the opposition parties but within the Congress Party as well. The Indians are very sensitive to outside pressure. A further limit on leverage is imposed by often difficult Center-State relationships. The State governments, for instance, have primary responsibility for the development of agriculture.

D. Personal Touches

From 1965-1969 the President of the United States himself played an important role in the leverage process with the GOI. He personally held up program loans and PL-480 agreements because of dissatisfaction with the progress of Indian economic reform, particularly in agriculture. The President held up authorization of agreements not just to exert leverage on Indian economic performance. Dissatisfaction with Indian foreign policy, especially concerning Vietnam, was important. (Often A.I.D. and the USDA have not known specifically why authorizations have been held up by the President.) Members of the U.S. Country Team in India have differed considerably over how forceful we should be with the GOI.

V. CONCLUSIONS

1. The bilateral A.I.D. negotiating strategy in the case of India cannot be analyzed independently of our relations with the other Consortium members, in particular, the IBRD.

2. The conditioning process in India, bilateral and multilateral, included continuing dialogues, annual negotiations and negotiations associated with specific loans. A.I.D. and the other donors were generally satisfied with the framework and promise of the Third Plan. Doubts as to the efficacy of Indian planning increased after 1963 and, in early 1966, the IBRD (with A.I.D.'s agreement) negotiated a set of new guidelines for GOI development policy. Bilateral and multilateral leverage since 1966 has largely followed that outline.

3. The ease with which committed loans were released in India without performance review, even after 1966, contrast with the rigorous tranche-release mechanism installed in Latin America. But the comparison is deceptive. Fighting issues in India were generally focused on GOI policy, and loan agreements were delayed pending GOI action. The American "presence" was probably as evident at the policy level as it was in Latin America. In India, it preceded rather than followed the loan commitment.

4. Bilateral discussions focused on only two or three discrete issues throughout the program loan period. The GOI was certain of A.I.D.'s priorities for self-help performance, and performance since 1966 has been more good than bad.

5. A.I.D.'s attention was on development policy, since the monetary and fiscal accounts were reasonably stable -- more than could be said for most program loan recipients. If India had been suffering from serious inflation, A.I.D.'s attention would have been diverted to stabilization policy and the conditioning mechanism might have been different.

6. The PL-480 program substantially reinforced A.I.D.'s hand. In fact, improvements in agricultural policy were linked specifically to the PL-480 agreement, and A.I.D. successfully joined these to the fertilizer conditions (which were either explicitly or implicitly associated with the program loan) to develop a substantial influence on Indian agricultural policy.

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PAKISTAN

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PROGRAM LOAN STUDY: PAKISTAN

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I. INTRODUCTION

In absolute size, program assistance to Pakistan represents the third largest A.I.D. effort in loans authorized, and the second largest in loans actually released ($794 million for FY 1962 through FY 1968). While the level of loans to Pakistan amounted to only one-half of the similar assistance to neighboring India, program assistance per capita was twice that available to the India economy. Viewed as a percentage of imports, program aid to Pakistan approached the highest granted to any country receiving program loans; it averaged 11 percent for the period.

The U.S. program loan experience with Pakistan is unusual in three respects. First, the negotiations over program loan conditions in FY 1962-FY 1968 were conducted with a single, stable GOP regime.* Secondly, U.S. assistance to Pakistan has been formally coordinated with other international aid sources, those organized in the Consortium led by the IBRD. Finally, while a variety of self-help measures have been urged upon the GOP during the period under study, there has been a greater concentration than in almost any other country case on a single objective; import liberalization.

This high degree of concentration on import liberalization was due to two major circumstances. There was a lesser need than in many countries for pressing for a wide range of objectives since, in general, the economic planning and economic policies of Pakistan had been reasonably satisfactory. On the other hand, as a result of structural changes in the economy, the need for increased amounts and greater flexibility in the import of raw materials and spare parts was a most compelling one. Their liberalization, however, was not easy to achieve because of certain risks inherent in the policy change and the strong opposition of certain vested interests that received large profits under the import licensing system.

The structural imbalance that characterized the Pakistani economy in the early 1960's -- and which made import liberalization such a seriously needed step -- can be traced in large part to the import licensing system established in 1952. In that year a foreign exchange crisis resulted in setting a rigid and detailed import licensing system for Consumer Goods, Industrial Raw Materials, and Spare Parts. The interpretation of "essentiality" in the allocation of import licenses was such as to give the lowest priority to Consumer goods, a higher priority to raw materials and spare parts, and the highest priority to capital goods. This allocation policy, coupled with high tariff protection, resulted in rapid growth of many domestic consumer goods industries between 1954 and 1959.

* This study covers only the period of FY 1962 through FY 1968. Consequently, the subsequent major political changes, important as they are, are not considered.

One of the elements determining who got raw material licenses was the capacity of the applicant's plant which would use them. This was a built-in incentive for excess capacity and a drain on scarce foreign exchange to provide it. Historical import patterns also continued to play a role in who got the import licenses. And, with an overvalued exchange rate, the high profitability of import licenses could support substantial bribes. Moreover, the use of a complex system in an economy undergoing rapid change inherently encountered many serious administrative problems. A major result of these forces, despite some improvements that had been made in the system, was a serious shortage of needed raw material imports for the operation of existing industrial capacity. These shortages were reflected in part in the composition of raw material imports themselves. An AID Mission survey of seventy-two plants in the fall of 1963 concluded that nearly eighty per cent were operating at only one third of capacity, and eighty-seven per cent cited the insufficiency of imported raw materials as the main reason.

The situation seems, particularly in retrospect, to have clearly called for import liberalization. It is true, of course, that further major improvements in the import licensing system could have mitigated at least some of the imbalances in the import pattern. But a greater role for market forces was plainly desirable. (De-valuation as a partial alternative raised a number of special problems and, as a practical matter, was considered a less useful negotiating objective. Consequently, it is not considered in the rest of this paper.)

Program loans, which were just coming into major use in the early 1960's, were obviously a very good instrument for achieving an increase in volume and improvement in composition of raw materials, components and spare parts (i.e., maintenance imports). Increased project aid, of course, could not accomplish this. Program loans, thus, not only provided a means for exercising influence in getting the needed policy changes, but provided, at least in part, the wherewithall with which to actually carry out the policy of liberalized imports.

Despite these factors -- which doubtless do appear somewhat neater and clearer in retrospect -- a major exercise in the use of influence was necessary to induce more liberalized import policies. Advice from various outside experts was sometimes conflicting in the degree of emphasis it gave to various policy instruments and this presented the Pakistani policy makers with some real problems of choice. Increased import liberalization, even if carried out gradually, carried inherent risks of depleting foreign exchange reserves if the demand should turn out to be greater than estimated or if the support of program lending should be subsequently reduced. And one cannot overlook the pressure of certain vested interests that made large profits from their preferred position in obtaining import licenses. And others, the State Bank in particular, opposed any changes in the price of imports. Moreover, many political leaders cautioned against undertaking what they considered to be a risky and unnecessary departure from established policy. The stage was set for a classic test of the ability of program lending to induce reform.

II. CHRONOLOGICAL SUMMARY OF PAKISTANI EXPERIENCE

A. Pre-1962 and Comparison with Non-program Assistance

Prior to 1962, most of the aid given by the U.S. to Pakistan was in the form of defense support and project assistance. Defense support was eliminated as a form of aid in FY 1963; project aid continued at high levels until FY 1964 and fell to low levels thereafter.

FY 1962 initiated a dramatic shift from grants to loans, a change dominated by the introduction of program assistance. Between the periods, 1957-61 and 1962-66, the per annum level of grants fell 51% while the annual loan level rose by 95%. In the earlier period loans represented some 56% of U.S. aid obligations; this figure rose to more than 83% of the annual aid package in the later period.

PL 480 aid was already at a substantial annual level prior to 1962 (about $64 million). During 1962-65 it rose sharply to an annual level of $166 million, an increase of 160% over the earlier period.

Throughout the period, the U.S. remained the single largest aid donor to Pakistan, contributing 40-45% of all foreign assistance. The next largest donor has been IBRD/IDA, accounting for some 16% of the annual package. Other Consortium members, especially Germany, Japan, the United Kingdom, and Canada, have provided 36-39% of the annual assistance program.

B. FY 1962: $90.0 and $42.0 Million

Two program loans, for $90.0 and $42.0 million, were made in support of Pakistan's generally acceptable second Five Year Plan, 1960-1965, and were not linked to any specific conditions. The level of aid was based on external resource requirements, particularly for maintenance imports. In the program loan documents, reference was made to recent Pakistan performance in introducing import liberalization measures and in the government's decision to increase its emphasis on agricultural development. These loans were made as part of the U.S. commitment, pledged at the January 1962 Consortium meeting, to make $240 million available in support of the second and third year (1961-1963) of Pakistan's Second Five Year Plan (1960-1965).

C. FY 1963: $30.0 and $70.5 Million

The first loan, of $30.0 million, was in further fulfillment of U.S. commitments to make available a total of $240 million in commodity aid in support of the Plan, as stated above. Although there were no specific conditions referred to in the loan paper, there was a statement to the effect that the January 1963 GOP decision to increase licensing of industrial imports to 100 percent of the 1961 import level, "presupposes foreign financing of the magnitude projected by the Planning Commission."

The second FY 1963 loan ($70.5 million) was additional support to the government's Plan requirements for maintenance imports. No specific conditions were stated in the loan documents, but reference was made to the fact that the aid was required to support import liberalization efforts.

D. FY 1964: $100.0 Million*

The first explicit use of the program loan as an instrument of leverage came with the $100 million loan of January 1964. This loan was directly linked to import liberalization for major iron and steel categories. The negotiations on the loan had been preceded by the USAID study noted above on raw material shortages and excess capacity and by extensive, continuing USAID-Pakistani discussions of the need for a reformed commercial policy system. A more specific argument was that, with rising Pakistani foreign exchange reserves at that point in time, it would be difficult to justify a larger program loan which might primarily be a contributor to those reserves. This circumstance strengthened the case for some import liberalization and, at the same time, reduced the risk of foreign exchange depletion.

The Pakistanis, who were not prepared for a full-scale liberalization, proposed that for the first half of 1964 there be free importation (i.e., no license required) of pig iron, tin plates, billets and strips from the United States. These limitations reflected a fear that, even for this limited liberalization, there might be a demand substantially greater than the AID financing through the program loan. On the U.S. side, there was concern that starting with a partial liberalization carried risks that some of the momentum for reform might be lost. On balance, however, the U.S. conclused that the limited liberalization would prove sufficently successful to encourage bolder steps at a later date. The end result was a $100 million loan (compared to the request for $130 million) of which $90 million was to be used for importation from the U.S. of the liberalized iron and steel items.

E. FY 1965: $140 Million

The U.S. judgment that limited liberalization in conjunction with the FY 1964 loan would increase the momentum was justified. The FY 1965 liberalization was a long step forward.

* Much of the information through FY 1965 is drawn from "A Case Study of Import Liberalization in Pakistan", dated April 2, 1965, which was prepared by the USAID Pakistan. To avoid cumbersome footnotes, no special citations are made even in those cases, of which there are several, where nearly direct quotations are used. This excellent study gives every internal evidence of being a perceptive and accurate description and assessment of events; it is also judged to be such by participants in the analysis and negotiations of the time.

The U.S. held to its position in the negotiation leading up to the FY 1965 loan that greater import liberalization was an essential part of the justification for continuing large-scale program lending. These views were concerted with IBRD officials. By March 1964, the Planning Commission economists were convinced of the desirability of further liberalization. (This, incidentally, provides an interesting element of one important facet of exercising influence -- governments are not monolithic and working with one element of a government can often lead to a broadened base.) The IBRD/AID position was that only a broad liberalization could justify the $200 million of Consortium commodity assistance being sought by Pakistan. Otherwise, the maximum justifiable level would probably be at most the previous year's level of $120 million ($100 million from the U.S.), or possibly less.

The Government of Pakistan was deeply divided on the issue of decontrolling imports. The man who resolved the conflicting pressures of insistent demands for import reforms, on the one hand, and domestically divided counsel and opposition on the other, was Finance Minister Shoaib. The nature of his negotiations with his colleagues is unknown. But the results are clear.

Mr. Shoaib was genuinely interested in making the liberalization as broad as aid financing and Pakistan's own foreign exchange would allow. He sought a minimum firm assurance of $170 million of commodity aid from the U.S. and the IBRD and asked for an assurance that AID would support the program for at least three years. AID responded by assuring that it would "sympathetically examine" a program loan application for $140 million for FY 1965 and would also "carefully consider" program loan applications of up to the same amount for FY 1966 and FY 1967.

After what the Mission describes as three exhausting weeks of negotiations in June (1964), the agreed package was that Pakistan would effect a substantial liberalization covering at least raw materials and spare parts, would finance Free List imports from its own resources, and would impose additional taxes on newly freed items of about 10 per cent. The U.S., as already noted, would consider a $140 million annual program loan for three years.

In his June budget speech, Finance Minister Shoaib announced the import liberalization policy. On July 2, 1964, the government published a decree removing licensing requirements for a total of 51 categories (including nearly all industrial raw materials and spare parts) and on July 14 applied surtaxes of about 11 per cent on newly liberalized items. At the Consortium meeting shortly thereafter, the U.S. pledged a $140 million program loan and the actual loan agreement for FY 1965 in that amount was signed in December.

F. FY 1966: $50.0 and $70.0 Million (from FY 1966 funds but made in FY 1967)

There was a long gap between the program loan of FY 1965, substantially agreed to in June of 1964 and signed in December, and the first loan of FY 1966, which was not signed until May 4,1966. A number of factors accounted for this, including the late appropriation of AID funds, which were not available until the fall of 1965. But, the major reason for delay was the India-Pakistan hostilities which broke out in September 1965 and the U.S. decision to withhold economic assistance from both participants until hostilities ended. In December 1965, the Presidents of the U.S. and Pakistan conferred and in January 1966 the Tashkent Declaration was signed between India and Pakistan bringing hostilities to a halt and laying the groundwork for a resumption of assistance negotiations.

In March 1966, a loan of $50 million was presented for approval in response to the cessation of hostilities and the subsequent disengagement of military forces as well as to balance the $100 million loan that had been made to India; the loan was signed May 4, 1966. The war and bad harvests had led to a deterioration in Pakistan's development program and this loan was considered interim assistance to meet the most urgent import requirements. According to the program loan document, the loan was subject to certain "understandings" (which were not really strict conditions), to wit:

> "1. Highest priority will be given to the allocation of domestic and foreign exchange resources to development purposes, and this priority will not be sacrificed to an arms race.
>
> "2. The proceeds of these loans and substantial amounts of other foreign exchange resources will be allocated to finance items needed to secure fuller use of existing capacity, as opposed to use for building new capacity or increasing reserves."

In June 1966, a $70 million loan application was submitted and the agreement was signed in August. This loan was regarded as a six-month slice of a contemplated $140 million in commodity lending for FY 1967. (This first loan was made from FY 1966 funds.)

G. FY 1967: $70 million (exclusive of the $70 million from FY 1966 funds)

The program loan for FY 1967 was, in effect $140 million, made up of two $70 million tranches. Although the first of these was, as noted above, actually made from FY 1966 funds, the basic rationale as well as the actual time of signing put both tranches in FY 1967. It will be noted that the amount of $140 million was the same as that for FY 1965 and corresponded to the earlier understanding with Finance Minister Shoaib.

The second $70 million was made contingent upon Pakistan performance in the areas of import liberalization and restoration of the development budget. It was stated in the loan paper that the former decision is affected by the loan "far more" than the latter. The GOP indicated that it planned to reestablish in FY 1967 the same free list of 56 items originally proposed for FY 1966, but which was not implemented. It further indicated that it would budget development expenditures for FY 1967 at $1,079 million, slightly under the level projected in the Plan but 46 percent over the [reduced] FY 66 development budget. Defense expenditures were planned to be reduced from $569 million in FY 1966 (5.4% GNP) to $472.5 million in FY 1967 (4.2% GNP). In support of its liberalization intentions, the GOP estimated it required $180 million in commodity aid in FY 1967. At the time of the loan, the GOP requested U.S. assurances that the second loan would be forthcoming so that there would be adequate external financing to support the anticipated increase in imports resulting from the liberalization.

Prior to initiating the second $70 million portion of the loan, there were bi-lateral discussions between Pakistan and the U.S. regarding the conditions stated above. The U.S. position on these matters was developed for the forthcoming July 1966 Consortium meeting, as follows: (1) ". . . the major focus" should be on import liberalization which is the "central immediate economic issue;" and (2) "as regards defense expenditures, we believe Pakistan has shown responsiveness to concerns we have expressed" but that nevertheless this topic should be considered within a multi-lateral context.

The second loan for $70 million was submitted in January 1967 and was signed in March 1967. The loan document stated that on July 1966, the GOP had introduced a free list of sixty-six items but that it was hedged by numerous restrictions e.g., commercial importers were restricted to only 40 items on the free list. Then in December 1966, the State Bank issued a requirement that all free list imports financed by Pakistan's own foreign exchange would be subject to advance approval by the Bank, in effect a partial reintroduction of licensing procedures reflecting concern at a drop in foreign exchange reserves from $226 million to $146 million from the first to the fourth quarter of 1966.

At the time this loan request was submitted, the Mission stated that development expenditures may fall short of targets and that the import liberalization program was being implemented more slowly than had been hoped. Despite these qualifications the Mission concluded that "under the circumstances" GOP performance on import liberalization in the first half of FY 1967 "coupled with the statement of intended action in the second half of the year appears to be reasonable fulfillment of the original U.S.-GOP understanding of import policy in connection with the second $70 million loan." In regard to both defense expenditures and import policy the Mission concluded that "on balance" GOP performance meets the terms of the earlier understanding.

H. FY 1968: $25.0 and $115.0 Million

Two program loans were negotiated for FY 1968, making up a total package of $140 million, which again reflects the level of the earlier understanding with Shoaib. At the Consortium meeting in London (May 1967) and in its program submission, A.I.D. offered to consider providing $140 million in commodity assistance during FY 1968. The first $25 million was committed to the partial funding of fertilizer requirements and was signed in October, 1967. The purpose of this loan was to support Pakistan's comprehensive plan to achieve self-sufficiency in food-grain production by 1970. The loan was conditioned on the GOP's securing an equal amount for fertilizer imports from other sources, on "continued good performance in expediting domestic production, and on improving the distribution of fertilizer and pesticides through the private sector."

In February 1968, a program loan request for the remaining $115 million was submitted for Washington approval. In an AID/W NESA Advisory Committee Meeting held in January 1968, self-help measures were discussed dealing with import policy, credit policy and the role of the private sector. The Committee, in a written assessment attached to the loan presentation, stated that over the past six months (i.e. since June 1967) Pakistan consistently had moved towards a more liberal import policy by (1) reducing administrative controls over imports; (2) raising the rupee price of foreign exchange for certain import categories and (3) encouraging exports. The Committee stated that the A.I.D. Mission "is being instructed to initiate discussions with the Government of Pakistan" on the question of its conservative monetary and credit policy. This latter issue was raised in reponse to the Mission's conclusions that "the total impact of [present] monetary and credit policy [may be] excessively contractionary, preventing possible investment which might be safely realized.

In summary, throughout the Program Loan period, the major explicit condition attached to the loan was the need for import liberalization. After the war, conditions were extended to include the level of development and defense expenditures, but, even during this time, it was stated that the "central immediate economic issue" was import liberalization. This does not mean that the Mission did not attempt to influence other phases of development policy, to the extent feasible. On the contrary, U.S. influence was felt throughout the whole development field. (See Section IV below.)

III. THE PRINCIPAL ISSUES

A. Did A.I.D. try to exert leverage with the program loans?

In 1963, the U.S. stated that it intended to use the aid program to induce self-help measures in those areas which it believed constrained Pakistan's development progress. Among the areas mentioned were population control, human resource development, development administration, agriculture, savings and taxes, exchange rate adjustment and trade liberalization, and industrial production. It is obvious that this listing covers most economic and social measures appropriate to the development process. The "immediate imperatives" were stated as exchange rate adjustment and trade liberalization.

In order to induce reforms in these areas, U.S. efforts were to be directed towards the establishment of conditions as benchmarks against which performance could be measured, as well as persuasion over time. It was stated several times that all aid instruments and programs would be used to induce policy changes in sectors where each instrument would be most appropriate. For example, PL-480 was one instrument used to induce change in agricultural policy. The U.S. planned to use the Consortium and the World Bank to press for reforms "in order to reduce the political context of such pressure."

In a more detailed discussion of the policy reforms mentioned above, it was stated that primarily persuasion would be used to induce self-help rather than any more formal and explicit method. The only reforms to which program loans were explicitly linked were exchange rate adjustment and trade liberalization.

As a result of the India/Pakistan war of September 1965, budgetary expenditures for defense rose sharply and between FY 1965 and FY 1966, doubled. After the conclusion of the war, this became "the most serious and immediate issue between Pakistan and the U.S. . . . " U.S. efforts were then additionally directed towards explicit containment of Pakistan's defense expenditures.

In summary, the U.S. has attempted to influence numerous aspects of the economy so as to ensure that Pakistan's development progress would be satisfactory. But in only one area, trade policy, does it appear that the program loan was used as an explicit tool of leverage.

B. Did Pakistan meet the performance standards of the program loans?

Throughout the entire period of the program loan, the USAID stressed the importance of import liberalization. Import liberalization was justified on the grounds that economic growth in Pakistan required a larger and more flexible inflow of raw materials and intermediate goods primarily to supply the existing industrial plant and essential agricultural inputs. It would also permit the market mechanism to more efficiently allocate resources than the cumbersome and complex system of controls that existed in Pakistan.

How successful were USAID efforts? There were a number of shifts in Pakistan's policy in this sector. These were due in part to changes in the level of foreign exchange reserves, including the major decline in 1966 noted above, and to the serious disruptive aspects of the India-Pakistan conflict of late 1965. But, aside from these breaks, the general trend was a favorable one. A NESA region document summarizes the outcome as follows: "by January 1968, when 80 per cent of industrial raw materials and spare parts were under limited or no controls and entered at 50 per cent or more above par value, we concluded that a satisfactory structure for achieving our objectives had been set."

The first major move in import liberalization was taken in January 1964 with the intorduction of a free list of four major iron and steel items which could be imported from the U.S. under the A.I.D. program without preliminary issuance of an import license. Subsequently, this list was expanded to include a total of 51 items and then in July 1965 expanded to 56 items. The free list was suspended in the fall of 1965 as a result of the hostilities with India, the suspension of U.S. aid commitments and the delay in new Consortium aid. In FY 1966, the free list was introduced for 31 items and then at the beginning of FY 1967 it was expanded to include 66 items. However, this liberalization was hedged by restrictions. During the fiscal year, further restrictions were imposed as a result of delays in non-project aid and the overall shortage of foreign exchange. For example, in December 1966, the State Bank issued a requirement that all free list imports financed by Pakistan's own foreign exchange required advance approval by the Bank, a retreat from previous liberalization efforts.

In presenting its FY 1967 loan recommendation, the USAID concluded that the GOP performance in the first half of 1967, "coupled with the statement of intended action for the second half of the year appears to be reasonable fulfillment" of the U.S.-GOP understanding.

Pakistan introduced an interim six-month policy in July 1967. This policy reduced the free list to 10 items; these account for about two-thirds of the volume of the previous list of 66 items. Fifty-three items were shifted to the bonus list and a new cash-cum-bonus category was introduced for nine items. Under this system, an importer had to surrender bonus vouchers covering 50 percent of his desired license entitlement in order to obatin a license. In July 19, 1967, seven items were removed from the bonus list on the grounds that there was sufficient domestic production.

In November 1967, the GOP introduced a number of import and export measures in response to the United Kingdom devaluation. The USAID concluded that the "actions taken immediately were appropriate balancing or holding operations." Initial steps were taken for future exchange rate reform by reducing the variety of export rates in existence. Several of the many measures taken by Pakistan were advocated by the Mission.

In January 1968, the Mission reported the introduction of a new import policy which "meets hopes and expectations for significant liberalization." The policy reduced controls over a large number of raw materials, intermediate and spare part imports and, at existing voucher prices, this will raise the effective price of foreign exchange by about 85 percent above par value for over half such imports, concluded the Mission. This new policy introduced a free list, cash-cum-bonus list, a bonus list and a license list. Although this new policy covered the period January - June 1968 only, the Mission said that the GOP "made the point that the general pattern is expected to be followed for the next several periods."

A review of these developments indicate that Pakistan's efforts to reduce its import controls was influenced to a large degree by the availability of external resources and Pakistan's balance of payments situation. Pakistan was particularly willing to reduce its controls when its external position was satisfactory. Restraints were re-imposed in part when its reserve position deteriorated and/or external aid was insufficient. Although the GOP appears to accept the theory that a free market mechanism is the best means of achieving efficient resource allocation, its actions are in part responsive to the above constraints. Overall, the record shows that Pakistan has introduced import liberalization measures within the constraints imposed by the availability of external resources.

On a number of fronts where the negotiating objectives were less clear cut there have also been favorable developments. Priority has been given to development rather than to defense, and the defense budget was reduced to about three percent of GNP after reaching a peak of about five percent shortly after the war. The revised Third Plan (1965-1970) places priority emphasis on agricultural development and has given additional resources to credit institutions which support private industry. Finally, in 1967, the GOP initiated a major campaign to curb population growth.

C. <u>Did A.I.D. get leverage that can be attributed specifically to the program loans?</u>

One important quality of the program loan was its ability to transfer rapidly and efficiently a level of resources that made import liberalization possible. In justification of the FY 1965 loan, it was stated:

> "External assistance in the form of commodity grants and loans has enabled Pakistan to make use of a relatively fast moving and flexible form of aid, which finances the importation of raw materials, spare parts and general equipment for industry, and supplements the amounts that can be made available for these items from Pakistan's own foreign exchange earnings."

A June 1966 cable from the Mission indicated that both purposes are served by the program loan, i.e. it gets necessary resources to the GOP and induces it to undertake specific self-help measures. The cable stated that, "2. Acting Director stressed need for bold action in present situation . . . Shoaib indicated he takes some chances; if U.S. assurances regarding second $70 million reasonably /assured/ he would expand present /free import/ list to include all 56 items on original FY 1965 Free List, 'plus some others'."

There is other evidence that import liberalization was dependent upon the amount of resources made available by the program loan. As late as 1967, the USAID stated, "Until recently the scope of import liberalization was determined by estimates of non-project aid availability." Since then, emphasis has turned toward establishing a foreign exchange system which allows the price mechanism to determine the level and allocation of import resources.

The FY 1968 Program Assistance Paper (dated February 1966) stated that the U.S. efforts to stress a market-oriented import policy met with little success because the additional resources to finance the increase in imports were not available. And the FY 1969 Program Memorandum (dated August 1967) stated that during the year the delays in non-project aid and a shortage of foreign exchange led to a reinstitution of some import controls by the GOP.

The program loan did in fact assist in inducing some import liberalization in Pakistan. However, there were considerable shifts in government import policy in response to the level of resources made available and Pakistan's overall balance of payments position. Thus, the leverage in aid was important in inducing self-help in this area, along with any leverage quality per se that the program loan mechnaism may have. The plain fact is that a program loan is such an apt instrument for supporting import liberalization that this aspect of its use and its use for leverage cannot really be separated.

IV DETERMINANTS OF LEVERAGE

A. The Loan

1. Size of Loan

Since 1962 U.S. program assistance to Pakistan has remained at a high level relative to foreign aid received from all other sources. Most of the time it approached fifty percent of total aid. It is a matter of record that the U.S. has enjoyed a dominant voice in negotiations over aid-related GOP policies. Granting the complexity of factors that produced this level of influence, the relatively high level of U.S. aid demonstrated a serious commitment to Pakistan's needs which, in turn, encouraged the GOP to give careful attention to A.I.D.'s policy recommendations.

2. Changing Aid Level

The one case where a changing aid level appears to have been of considerable importance was in FY 1965. The $40 million increase in program lending for this year was justified only because of the substantially increased liberalization; the alternative, in the absence of liberalization, would have been the FY 1964 level of $100 million -- or less. Here again the interrelationship between the program loan as a means of financing import liberalization and as a means of inducing import liberalization defies precise disintanglement. But it is clear that the movement to a greater degree of liberalization and to a higher level of program assistance came at the same time and that they were related.

For the remaining years, it seems best to think of them as a continuation of the $140 million annual level with a hiatus caused by the war and some confusion from the fact that half the FY 1967 level was funded with FY 1966 money. After allowing for these, the general pattern is one of continuation of both import liberalization and program loans at relatively high levels.

3. Dissipation Through Time

There is no evidence that leverage from program loans diminished over time in the case of Pakistan. Those who were associated with the loan negotiations and with the continuing discussion of Pakistani development problems feel that, on the contrary, there was a perceptible growth of A.I.D.'s influence over the years. There was an increased degree of mutual agreement regarding the goals and strategies most favorable to development and, therefore, less friction over the definition of mutually satisfactory loan conditions. This result was probably due to the Mission's emphasis on persuading the GOP to view proposed measures as its own proposals before they became loan conditions.

B. The Conditioning System

1. Number of Loan Conditions

Few explicit conditions were attached to program assistance to Pakistan. Some of the loans were lightly conditioned and others were free of formal conditions. When conditioning was employed, emphasis rested on only one or two policy objectives. The personnel involved justified this procedure on two grounds: (1) neither the GOP nor A.I.D. had an adequate staff to deal with more than a few major reform objectives at any one time; (2) in Pakistan the program loan was normally designed to finance the desired reform measures -- i.e., import liberalization -- hence, it was not easy to introduce reform measures related to other areas of the economy as loan conditions.

2. Specificity of Loan Conditions

The major explicit condition attached to program assistance was that of import liberalization. Other self-help conditions were explicity discussed over the years but the Mission relied on persuasion rather than written conditions to secure GOP action on them. A borderline case is represented by the "understanding" attached to the first postwar loan to the effect that resource allocation policy would give top priority to development needs as opposed to expansion of the defense sector.

3. Area in Which Conditioning was Exercised

Import liberalization was a consistent and explicit theme in all A.I.D. program loan negotiations with the Government of Pakistan. Each loan was justified on the grounds that import liberalization, which was considered a major requisite for further growth in Pakistan, would result in increased import levels that the GOP would be unable to fund with its own foreign exchange earnings. The program loan was an essential means of partial funding of import requirements. The Country Assistance Strategy Statement of December 1963, indicated that A.I.D. would use persuasion and loan conditions as a means of influencing GOP actions in this sector. The program loan documents did not state the precise conditions that would be required for any loan, although there appears to have been considerable U.S./GOP discussion on the type of reforms that should be implemented. Generally, loans were given in support of actual trade liberalization measures with concurrent statements to the effect that additional reforms in this area were necessary. There also was a continuous but less urgent dialogue between the USAID and the GOP on the various other policy reforms that were desired.

4. Rigor of Loan Enforcement

The approach used by the U.S. to influence Pakistan's policies differ in degree from the approach used elsewhere, particularly in Latin America. The conditions set by the U.S. (and the Consortium) were generally stated in broad terms without explicit and precise targets established and without specific time limits set in performance. Negotiations did indeed take place with the GOP and program reviews were made in depth by the U.S. and the World Bank (for the Consortium). Nevertheless, there was no formal stipulation that funds would be released contingent upon specific GOP performance nor were conditions presented in a detailed written form as was done, for instance, in CIAP letters. The enforcement technique used in some cases was however a very rigorous one, i.e. to postpone the signing of loans until the desired conditions had in fact been met. Was this general approach any less successful than the more detailed approach applied to some other countries? Apparently not, for Pakistan has introduced many of the types of reforms recommended by the U.S. and other donors. However, one cannot thereby conclude that this attitude toward enforcement applied in Pakistan would be equally productive in other countries confronted with a far different set of development problems.

C. Environmental Factors

1. National Politics

The competence of segments of the GOP, and government stability and commitment, established a favorable environment in which efforts to reform and modernize the economy were possible. Development planning and implementation was rather sophisticated and during the second Five Year Plan, Pakistan made major economic gains. The assistance rendered by the Harvard Group and the national leadership of President Ayub and Finance Minister Shoaib appear to have been important factors in Pakistan's forward movement. The degree of U.S. influence was favorably effected by these conditions. Further, this environment allowed the Mission to deal with the GOP on all of its development policies irrespective of, and unrelated to, any one specific aid instrument. As the FY 1965 Program Memorandum stated:

> "Broad policy changes . . . , sectoral policy changes . . . and self-help measures have been and will continue to be pursued as part of our general aid relationship and on individual programs."

It is obvious from an overall reading of the U.S.-Pakistan experience that U.S. influence was efficiently directed, and favorably received, because of the responsiveness of the GOP and its own ability to direct Pakistan's development progress.

2. U.S.-Recipient Dipomatic Relations

Aside from the period of the Indian-Pakistani War in 1965, U.S.-GOP relations have been friendly. Two principal factors have combined to produce this climate for negotiations. First, the GOP has accepted a foreign role in the formulation of its development program. Perhaps because A.I.D. negotiators relied on persuasion rather than on threats to win GOP acceptance of desired policy actions and certainly because A.I.D. made allowances for the limited political power of GOP negotiators over dissenting government colleagues, the relationship was free of constant friction and occasional crisis. Secondly, U.S. aid to Pakistan was sometimes clearly and always in some degree measured by the current assistance program to India. A.I.D.'s care to avoid charges of favoritism in this respect was a necessary condition for the maintenance of continued good relations throughout the period.

3. Multilateralism

As mentioned in section II.F. above, the U.S. planned to use the Consortium and the World Bank to press for reforms of all kinds. The Pakistan Consortium, set up in 1961, includes nine donor countries under the Chairmanship of the World Bank. The members of the Consortium meet to review economic progress and actually pledge specified amounts of aid to the recipient. Prior to Consortium meetings, the Bank sends a team to review Pakistan's progress and assess the need for external resources. The Bank report then becomes the focus of discussion at the meeting. In its report, the Bank suggests various policy prescriptions in such areas as foreign trade, investment allocation and fiscal and monetary policy. These reviews are low-key and do not explicitly suggest that the level of aid would depend upon future self-help activities; usually aid was given in response to satisfactory reviews of past performance. Obviously, there may always be an implicit threat that aid would not be forthcoming, or would be reduced, if reforms were not implemented. Nevertheless, this approach does differ from the formal and explicit tranche release process used in Latin America. The individual members also present their views on areas requiring policy reforms and a general consensus is developed representing the views of the Consortium as a whole.

The U.S. role in the Consortium is intensive, and it is somewhat difficult to speak of Consortium influence without considering the impact of the U.S. on Consortium policy prescriptions. At the same time the World Bank also has been active in this area and in its numerous bilateral discussions with the GOP clearly indicated that reforms were necessary if Pakistan expected to receive adequate assistance. The U.S., the World Bank and the Consortium did make effort to influence government policy across-the-board. Assistance was given to Pakistan usually because it had introduced reform measures which were in line with the general recommendations made by the donors. For example, at the Sixth Consortium meeting (July 1964), the Chairman stated that in the previous meeting "views were expressed on the need for the Pakistan Government to take action to free the economy from some of its controls [and] emphasized the importance of moves to liberalize the import program." As Pakistan "has now adopted the kind of import liberalization this group has been urging her to undertake . . . it is now up to the members of the Consortium to help Pakistan in carrying out this program. The kind of help she needs . . . is non-project aid to bolster her foreign exchange resources against the possibility of a drain on them arising from this program." There is no evidence that the U.S. or the World Bank formally "threatened" to withhold aid if specific measures were not undertaken. (Obviously this "threat" is implicit in any aid program and may result from developments in the donor country as well as in the recipient.) Only at the time of the India-Pakistan war was aid -- economic and military -- withheld by the U.S. and the Bank, but this was a fact not a threat. It was one, but not the only, reason why hostilities ceased between these two countries; world opinion and domestic economic repercussions obviously affected this decision.

The Consortium related its offers to aid to Pakistan to the recipient's past performance in specific policy areas and at the same time recommended further changes in policy. Among the Consortium recommendations were the following:

(1) Import liberalization, including a consolidation of the free list to eliminate inconsistencies and bottlenecks;

(2) Restraining deficit financing. The Consortium suggested that revenue be increased by raising direct taxes, particularly those having higher agricultural incomes;

(3) Control of population growth;

(4) Relaxation of domestic controls; and

(5) Increased emphasis on agricultural development.

These recommendations have been made in one form or another since initiation of the Consortium. The World Bank and the U.S. continually emphasized that more and more assistance was necessary in the form of non-project aid rather than project aid, and the Consortium indeed has moved sharply in this direction. Most of the U.S. and Consortium aid in recent years has been in the form of non-project loans. Does this necessarily indicate that influence mainly resulted because of the specific aid instrument used, i.e., the program loan? The program loan was the appropriate form of aid required to support import liberalization. At the same time, the existence of an international mechanism which coordinated donor aid policies and which had at its disposal a vast amount of funds to support Pakistan's requirements and programs, was an important factor in affecting the direction which development policies would take in Pakistan. The Consortium approach was low-key and made "recommendations" and "suggestions" to the GOP rather than attaching "conditions" to assistance. Given these factors, Consortium/World Bank influence and leverage might have been quite effective regardless of the form of aid.

V CONCLUSIONS

1. The USAID Mission did attempt to influence Pakistan's development policies and programs and did use program loans as one means of doing so, through support of import liberalization measures. This is the main conclusion.

2. In addition, subsequent to the India/Pakistan war, re-establishment of development priorities and limitation of defense expenditures were major conditions. As regards policy changes in these two areas, the program loan should not be given sole, or possibly even major, credit for the success which was achieved. Other factors played a role, e.g.,

(a) The war, coupled with bad harvests, had a serious adverse effect on the economy of Pakistan. The domestic depression which ensued as well as world opinion undoubtedly were important factors in Pakistan's return to development priorities; and

(b) The postponement of the Consortium in September 1965 and the cessation of U.S. aid reduced total external resource availabilities to Pakistan. It was stedfastly affirmed that aid from all donors would be resumed only if the war ended and Pakistan put into effect the priorities mentioned above. As this factor included total external aid resources it would be simplistic to credit the program loan per se with the major share of influence.

3. The program loan had certain characteristics which made it particularly appropriate as a means of influencing import liberalization. First, program loans supplied the types of commodities -- raw materials, intermediate goods and agricultural inputs -- which the Mission and the Consortium considered an essential requirement for further growth of the economy. Second, it supplied a large part of the total quantity of resources needed to support the increase in imports resulting from the liberalization measures. Thus, it is exceedingly difficult, even in this one area, to separate out and credit a leverage quality per se to the program loan instrument.

4. Pakistan's performance and policy changes can be credited to factors other than direct U.S. influence. The GOP, or segments thereof consisted of responsive, capable and dedicated persons interested in social and economic progress. The Harvard Group, the World Bank and the Consortium played active and vital roles in ensuring that appropriate policies were undertaken. Government stability allowed for a basic policy continuum which might not have been possible in a more unstable political environment.

TURKEY

by

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PROGRAM LOAN STUDY: TURKEY

I. INTRODUCTION

Balance of payments support has been a central component of U.S. assistance to Turkey since the inception of the aid program. The first program loan was made in FY 1963, replacing at about the same level the DS/SA commodity import grant program of earlier years. There has been a program loan each year since. Through FY 1966 these loans remained near the $70 million mark, but by FY 1968 the level was down sharply to $40 million.

U.S. Official Commodity Import Aid to Turkey
($ millions obligated or granted)

DS/SA	FY 58	FY 59	FY 60	FY 61	FY 62	FY 63	FY 64	FY 65	FY 66	FY 67	FY 68
Grants	66.9	99.8	80.8	79.0	56.0	52.8	4.7	-0.2	--	-0.3	
Program Loans						35.0	70.0	80.0	70.0	65.0	40.0

A two-tranche system was introduced in the FY 1964 loan and continued through FY 1967. It matched the Turkish semi-annual import accounting system, thus permitting each tranche release to be related to a discrete import program. With the FY 1968 loan, all funds were released at once.

A technical assistance program has continued throughout the period, averaging around $4 million since 1960. PL-480 Title I programs began in the early 1950's as well. The Title I level jumped from $20 million in FY 1961 to $100 million in FY 1962, back to $43 million in each of the next three years, to $13 million in FY 1966 and to zero in FY 1967. PL-480 Title II grants have been made for many years, mostly through voluntary relief agencies.

Project lending started in the late 1950's. Except for the $120 million FY 1961 loan for the Eregli Steel Plant, the level of project lending was relatively modest until FY 1964. Since then it has averaged around $60 million per annum--almost equal in size to the program loan component.

This discussion ignores the military aid program, which has been maintained at a high level since the late 1940's.

For many years the U.S. was the only major donor operating in Turkey (although significant amounts of supplier credits and other less concessional capital flows were provided by various European countries beginning in the mid-1950's). West Europeans considered Turkey's perennial balance of payments deficit and other economic difficulties to be primarily American problems. The Turkish Consortium was formed in 1962, under the aegis of OECD, mainly as a U.S.-inspired means of increasing aid from other donors. The non-U.S. aid share rose from 10% (on a commitment basis) in 1960 to 60% in 1967. The U.S. argued in Ankara and in the OECD that other major donors had comparable interests in Turkish economic prosperity, and these arguments bore fruit.

The Consortium members include all the major developed donor countries (except Japan), plus IBRD/IDA and the EEC's European Investment Bank. The Consortium got off to a slow start (1965 was the first year it mustered the resources agreed by its members to be required) and has not yet developed the strong common position on economic reform which has been achieved by IBRD-led Consortia elsewhere (reportedly, only the IBRD and EIB have shown interest in self-help conditions for Turkey). Thus, in representing its own bilateral interests and as the only locally based spokesman for the Consortium aid agencies, the USAID Mission often has been alone in trying to influence GOT development policy.

This has not been the case, however, for monetary and fiscal policy. The IMF has concluded a Stand-by agreement with Turkey every year since 1960 (the figure has fluctuated between $21.5 and $37.5 million). Each agreement has described monetary and fiscal conditions which the GOT was expected to meet. Most conditions included quarterly or semi-annual indicators. Thus, in this important policy area, the U.S. has not had to take the lead. Further, though relations with the IMF are close, the U.S. has not tried to influence the shape of the annual IMF-Turkish agreement.

Turkey, with a population of 33 million, received twice as much annual U.S. program loan aid per capita as Pakistan, and four times as much as India. As a percentage of the Turkish total import bill, however, U.S. program loans have run at about the same figure as they have in most other program loan countries, including Latin America (10%).

II. CHRONOLOGICAL ACCOUNT OF TURKISH EXPERIENCE

A. Pre-FY 1963

Annual negotiations were held to determine the size of the SA balance of payments grant. The negotiated figure invariably fell below the Turkish request, but the discrepency could be explained by lower U.S. estimates of the payments gap. Self-help criteria were not plugged into the formula. Such language as the following was used by the Mission in that period: "in some cases it will be useful to indicate to the GOT that unless certain measures are taken, further technical assistance and/or development loans in that particular sector would not appear useful," but it is clear that the threat was rarely conveyed and never related to the aid level in general or to the program grant in particular.

The reason was frankly stated in the FY 1963 Field Proposed Program submitted in December 1961: "we have interests in Turkey, primarily military in character, which must not be jeopardized by abortive attempts to force economic reform." The fact that such attempts were prejudged abortive is attributable to two considerations prominent in the thinking of both GOT and Mission officials: that without vast structural changes a balance of payments deficit was unavoidable in the near future, and that the U.S. Government would not risk losing its strategic position in Turkey by withholding balance of payments support in case of poor performance. Moreover, the Turks were firmly convinced that in their military/political posture they were already furnishing more than adequate justification for U.S. aid.

Nevertheless, the U.S. did make some attempt and enjoyed some success in influencing the course of GOT economic policy. This is particularly true of the period after 1960, when a young and progressive military regime took over from the Menderes government. According to documents of the period such influence was extended in informal ways--discussions and letters of recommendations rather than demands and signed agreements. Turkish officials were particularly sensitive to any act that could be interpreted by the opposition as concessions to foreigners, and would probably have rejected aid out of hand rather than be forced into a compromising position. U.S. influence was attributable to no specific component of the aid program, though the commodity import grant opened a door to discussion of balance of payments problems that otherwise might have been shut. In the December 1961 program submission a host of self-help measures "which USOM believes can and should be undertaken by the GOT" were listed by sector, including planning, education, water resources, manufacturing, agriculture and an omnibus "general" sector. A dialogue on many of these matters had long since been established. In this and other documents of the pre-FY 63 period the Mission claimed a share of the credit for (1) establishment of the State Planning Office in September 1961 and formulation of the First Five Year Plan 1963-1968, (2) preliminary investigation of the finances of the State Economic Enterprises and first steps toward their reorganization and rationalization, (3) introduction of an agricultural income tax, (4) a new policy on population, and (5) various other self-help accomplishments. The degree of the Mission's influence in these areas can be questioned, but it had clearly established an interest in, and probably had some influence on these matters. Since there is no evidence that whatever influence the U.S. had was attributable to aid conditioning, we must suppose that it stemmed simply from a healthy relationship between GOT and Mission personnel, GOT respect for U.S. views on economic reform, and the GOT's own desire (after 1960) to do many of the things that Mission advisers were advocating.

B. FY 1963: $35 million

FY 1963 saw the beginning of the transition from grant to loan commodity import finance. $35 million of DL funds were authorized in June 1963 (and agreed in September), to help cover licensing of imports under the July-December "Eleventh Import Program," in effect enabling orderly deliveries through the first half of FY 1964.

In keeping with the self-help theme then beginning to be enunciated in AID/W, the Mission attempted to write into the loan agreement four rather mild covenants on GOT economic policy. An AID/W communication to Ankara endorsed the move, stating that "we wish to reaffirm the principle that Program Loans be utilized to establish and promote more effective working relations, with conditions on basic policies such as those contained in the first four program loan conditions. Furthermore, the GOT must be brought to recognize that future program loans will be reviewed in light of performance on these policies." AID/W noted that explicit conditions had been successfully negotiated in Latin America, India and Pakistan (the allusion to India and Pakistan appears to have been fanciful).

The Mission replied that it was attempting to develop a course of action which would satisfy the new A.I.D. thinking on the tightening of criteria, but the negotiators had to recognize they were working from a base of 15 years of generous, untied aid. The Mission also complained that AID/W may have delayed approval of the draft covenants too long, since there was no longer sufficient time for a soft sell approach to the GOT before the end of the 1963 fiscal year.

As it turned out, the confrontation between the Mission and the Ministry of Finance was close to disaster. Memduh Aytur, Secretary General of the Organization for International Economic Cooperation (in the Ministry) summarily rejected any explicit conditioning language in the Agreement, and, when the U.S. tried to substitute side letters authenticated by the Minister of Justice, rejected them as well. Of no avail were Mission protestations that the conditioning language, which asked only for consultation before GOT took action in stipulated fields closely related to trade policy, was softer than that executed elsewhere. Aytur agreed in full to the substance of the conditions. But he vigorously asserted that U.S. insistence on written commitments was not only a breach of sovereignty and a profession of no confidence, but a poor way to reward the Turks for their demonstrable achievements since the revolution of 1960, as well as a strange way to close out a grant program and shift to loans.

In the period June-August 1963, the ground rules for the conditioning process in Turkey were gradually hammered out. The system eventually agreed upon was to include a Preamble to the Agreement which referred to the few broad areas of economic policy in which GOT performance would be subject to critical review in succeeding negotiating sessions. No economic indicators were listed among the conditions. No tranche mechanism was established in the FY 1963 agreement. Over the next five years this conditioning system was gradually tightened, but one of its most visible properties--the absence of explicit, written conditions involving specified public policies in any bilateral document signed by the GOT--remained unchanged.

C. FY 1964: $70 million

In January 1964, four months after the signing of the FY 1963 loan, A.I.D. pledged at the Turkish Consortium meeting $70 million in program funds for FY 1964. The loan was signed in April 1964. It was released in two tranches--$30 million in June and $40 million in August.

In terms of formal aid conditioning, the FY 1964 loan agreement was slightly more explicit than the previous one. There was, as there had been in FY 1963 and would be in most later agreements, the standard "whereas" clause in the Preamble highlighting the three or four major priorities of economic policy.

> "Whereas the U.S. Government recognizes that the Government of Turkey is undertaking to accelerate its economic development in stability and within the framework of the Five Year Plan approved by the Turkish Grand National Assembly; . . ."

There was also a clause among the Conditions Precedent which explicitly linked the release of the Second Tranche to Section 201(b) of the Foreign Assistance Act of 1961 as amended, the section which enjoins the U.S. President in a DL determination to consider alternate sources of finance, technical soundness, relation to development, the country's responsiveness to the needs of its people, and demonstrable self-help. The Turks were unhappy about including the last two points, which they considered bordering on written evidence of interference with economic policy. But they signed anyway. In the Program Assistance Paper submitted in February 1964 the Mission remarked that this conditioned second tranche mechanism would give it an additional opportunity to discuss economic performance with the GOT. However, other material indicates the Mission was not as enthusiastic as AID/W about using this device. Furthermore, the issue seems not to have been brought up prior to release of the second tranche; in any case, there was no delay in releasing the tranche.

Aside from these nominal shifts in formal conditioning, there was also a sharpening of the leverage philosophy. In the first LAS review (September 1963), it was argued that a minimum of $40 million in program loan funds was needed annually to protect the U.S.'s politico-military position in Turkey. Above that figure "the U.S. has the opportunity to consider GOT performance in implementing the development program as a factor in determining its volume of assistance... without endangering its security interest." Elsewhere the LAS warned that since political and military requests on top-level Turks were frequent and drew heavily on Turkish good will, only the most urgent and essential development self-help issues should be presented. But this "go slow" policy also reflected the previous creditable performance of the Turkish authorities. Only if the GOT abandoned its policy of planned, coordinated rapid development and fiscal responsibility, the LAS said, would it be appropriate for the U. S. to consider attaching stricter conditions.

It is hard to determine from the written record how serious the Mission was about conditioning aid on performance. On the one hand, it indicated it was prepared to tighten the screws on the Turks if they didn't do well; on the other hand, it said that the Turks were in fact doing well and U. S. interference was unnecessary. Obviously, the debate over what to include in the Loan Agreement was incidental to the fundamental issues of self-help and leverage. The economy was performing well. The GOT was performing very well in fiscal and monetary policy, an area on which USAID did not focus its conversations with the GOT but did make the GOT aware of latent USAID anxiety should IMF stability indicators be exceeded. The GOT was also performing satisfactorily in two areas which USAID did stress -- reorganization of the State Economic Enterprises and comprehensive planning. The Mission Director had addressed several letters to the GOT suggesting improvements in the field of foreign exchange earnings, particularly in exports, tourism and workers remittances. There had been no progress in this field for years and little evidence of GOT concern. But USAID in FY 1964 was only beginning to gear up for a major assault on foreign exchange policy, and couldn't have faulted the GOT for not meeting U. S. priority recommendations in this area since they had not been previously communicated.

D. FY 1965: $80 million

An FY 1965 program loan agreement for $70 million was signed in January 1965. This sum was to be released in two tranches, the first immediately and the second, for $30 million, in July. In fact, the second was released ahead of schedule. The original authorization had specified $80 million for FY 1965, but Mission and AID/W strategy was to withhold $10 million from the original agreement in hopes of prodding other donors into increasing their contributions and forcing the GOT to take action on two specific projects (local cost financing at Eregli and access roads for CENTO stations). In two separate actions ($4.2 million in September, $5.8 million in November) the loan agreement was later amended to increase the total to $80 million.

Correspondence between the Mission and AID/W in August and September indicates that GOT compliance with the project requests was assured before action was taken to amend the agreement. Elsewhere there is evidence that by July the Mission felt that delay in pledging the $10 million had induced all the extra Consortium aid it was going to, and further withholding would be counterproductive. It was clear by then that the 1965 Consortium fund raising exercise had been successful. Thus, for the first time, one could speak of a functioning tranche conditioning process, related to the $10 million increment.

The $30 million second tranche, however, was released without any economic review. The loan agreement had omitted reference to Section 201b (or similar economic undertakings) among the Conditions Precedent and even omitted the Preamble. Except for the handling of the $10 million, the formal conditioning process in FY 1965 was therefore weaker than it had been in FY 1964. This may reflect in part the transition in political power that occurred during this period: the transfer of control of the coalition government from Mr. Inonu's RPP to the reconstituted Justice Party (the JP took power in March, just after the Agreement had been signed).

Mission philosophy on program loan leverage had not shifted much, despite a change of Mission Directors in the summer of 1964. Given the American political and military interest in Turkey, there was still thought to be little scope for manipulating the aid level to induce self-help. The FY 1967 CAP submitted in July 1965 restated the maxim that it would be impossible to use the ultimate threat of cutting off aid as a bargaining weapon because the credibility of the threat would have been slight. The Mission was even more reluctant to make such a threat explicit in the loan agreement. It felt insistance on this point would only sour the negotiation process, and would not lead to measurably improved self-help performance. In any case it was not impressed with the argument that self-help performance ought to be one of the primary determinants of levels of program lending. The preferred field tactic was to continue the informal dialogue with GOT officials on the few topics which A.I.D. considered required priority attention. The Mission did not pretend that the results of its style of leverage had been or would be striking. It noted that where there was good performance it came from the conviction of the Turkish leaders that these policies were important. Where there were gaps--"as in foreign exchange earnings"-- there had been problems in influencing the authorities to effect changes. Although the dialogue had been extensive, much of it had been consumed in wrangling over questions of implementation, such as those connected with the Eregli Steel project. There was a limited capacity to influence matters of general policy, and within that constraint the Mission felt only a few topics "could be entertained in serious discussions over any particular period."

Despite continuing doubts as to the ultimate extent of their power, USAID officials nevertheless had become convinced that the program loan negotiation was the effective focal point of discussions about economic policy. They felt the fact of the loan, rather than the threat of its withdrawal, provided an entrée to important decision centers and that American opinions would not be disregarded. In a communication dated December 1964, the Mission reminded AID/W that in practice there was no explicit linkage between program aid and the ceaseless talks with the GOT on self-help. Rather it was the continuum of exchanges, against the background of program lending "which should lead to those policy changes at which we are aiming."

In mid-1965 the Mission prepared an Assistance Completion Plan, designed to show what, generally, the Turks (and the donors) would have to do if concessional aid were to be phased out by the end of the Second Plan period (1972), as desired by the GOT. The USAID negotiating strategy formulated in this context took the following shape. Highest priority was given to increasing foreign exchange earnings. A list of administrative and legislative changes was proposed, dealing with both commodity exports and invisibles. Among the former, a shift away from traditional export crops was advised. Among the latter, workers' remittances and tourism appeared particularly promising. Over and above those particulars, the U.S. called for a marked increase in the urgency attached by the Government to increasing foreign exchange earnings. The Turks had grown accustomed to a stagnant export profile and an annual trade deficit, and preferred to avoid the structural adjustments, particularly in the private industrial sector, that their elimination indicated. Needless to say, complacency with a level of program loan support in a country destined to graduate in the foreseeable future was abhorent to A.I.D. and the Mission was urged to toughen its posture on this issue.

The other areas of U.S. emphasis were:

1) comprehensive planning, which, after the fanfare accompanying the creation of SPO and publication of a Five Year Plan, had not lived up to expectations;

2) reorganization and rationalization of the State Economic Enterprises, which had annual sales of $1 billion/and accounted for 20% of all investment in Turkey, but could not finance their own expansion programs and were inefficient in terms of world prices;

3) a better deal for private investors, including foreign investors. The RPP Government had resumed the statist policies of the pre-DP period. Private industry had been practically disenfranchised. While all parties shared a distrust of foreign capital, there were many opportunities to exploit that source profitably without infringing on national sovereignty;

4) monetary and fiscal stability, which both A.I.D. and the Turks considered essential to the viability of the development process, had been handled extremely well (with IMF assistance) since the officers' coup of May 27, 1960 put an end to the excesses of the Menderes regime; the U.S. preferred to leave the subject to the IMF, with careful monitoring by A.I.D. and other Consortium members to ensure that early warning indicators of a resurge of inflation were recognized and dealt with expeditiously.

E. FY 1966: $70 million

The FY 1966 loan was signed with the new Demirel Government in March 1966. Two tranches were designated ($30 and $40 million), the second to be released sometime after June (it was released in August). A Preamble noted GOT intentions to (1) accelerate economic development, (2) maintain price stability, (3) increase foreign exchange earnings and (4) consider plans for import liberalization.

The design of the mechanism for release of the second tranche departed from the previous blueprint. Pre-loan negotiations had identified, as usual, the policy areas in which performance was expected. But quantitative tests of performance were also established. These included mid-year targets. In theory the second tranche would not be released until USAID was satisfied with performance, measured against those quantitative targets. Thus for the first time (excepting the $10 million for FY 1965 increment) a mid-year review was programmed to play a significant role in the loan process. Furthermore, the GOT gave tacit approval to these arrangements.

The reasons why the USAID shifted to a more formally conditioned tranche release mechanism at this time are clear. During the second half of CY 1965 there was a sudden spurt of inflation, from an annual rate of 4% to 9%. The new Justice Party government seemed somewhat less disposed to deal sternly with the problem than had its predecessor. The USAID, which had long maintained a continuing surveillance of stability indicators while leaving the dominant role in the field to the IMF, decided to make an explicit and forceful assertion of the importance it attached to the issue. It did so by adopting explicit conditions as prerequisites to release of the second tranche.

Three conditions were set. The first, which incorporated the IMF Stand-by Agreement of February 1966 and a few quantitative fiscal indicators devised by USAID, called for the restoration of price stability. The second urged an increase in foreign exchange earnings; various possibilities for accomplishing this were enumerated, with emphasis on tourism and the development of exportable forest and mineral resources. The third condition called for development of a program for import liberalization. This was a new item in the mix of U.S. proposals. Its introduction was predicated on a belief that the continuing unsatisfactory performance of the private sector was as much a function of a hostile import regime as of the discriminatory fiscal policies of the previous administration. The Demirel Government had made major accomodations to the private sector elsewhere, but not in the import field, and USAID shifted gears accordingly. But the USAID position had not yet crystalized, since it was not apparent how far liberalization could be pushed without reform of the foreign exchange system. Nor was it clear whether devaluation would be successful. Economists at the Mission were studying these questions throughout 1966. Token progress indicators of liberalization were specified, for example moving a few key commodities from the quota list to the free list, but the timing was left vague. Several messages between USAID and AID/W indicate that neither was prepared to push the liberalization issue at that time.

As in previous years, performance was pretty good and it is impossible to determine whether poor performance would have interfered with the release of the FY 68 loan. Under the tranche process that had evolved in Turkey, the original Agreement and release of the first tranche were supposed to reflect U.S. satisfaction with accomplishments of the preceding year, while release of the second tranche was pegged to accomplishments up to June of the current year. Most of the indicators in both periods were good. Prices rose rapidly after July 1965, but the GOT moved quickly in the Fall of 1965 to restore stability and -- according to the IMF, the Mission, and all indicators after February 1966 -- succeeded. Furthermore, the other major area of U. S. interest export earnings -- showed spectacular improvement. Commodity exports jumped 10% in both 1964 and 1965. Remittances from Turkish workers in Germany and other West European countries soared to $70 million in 1965 (from $0.1 million in 1963 and $9 million in 1964), partly because of boom conditions in West Europe but also because the GOT had instituted a highly successful exchange rate premium for money remitted to Turkey through legal channels. Furthermore GNP and aggregate savings indicators compared very favorably to those of other LDC's. It would have been difficult to delay either the signing of the Agreement or release of the second tranche on performance grounds, unless A.I.D. had wanted to take the Turks to task for having permitted the credit expansion of 1965, which fed the price rise in the first place.

But there was a problem with performance, as was highlighted in a June 1966 cable from AID/W. In that message, AID/W authorized release of the second tranche but refused to accept the favorable review by USAID of Turkish performance. The difficulty was in the divergence of macroeconomic performance and self-help. AID/W noted that while Turkey's economy had performed well this/was largely attributable to exogenous forces. GOT self-help was deficient in several demonstrable respects. The commodity exports that had done well were the traditional agricultural crops, and they simply rode the crest of world demand. The GOT had done little to exploit state-owned mineral and forestry resources, or to breath life into the incipient export promotion campaign. Worker remittances had been encouraged by the GOT, but the main explanation for their fantastic growth was the German labor shortage. Even the fiscal measures taken by the Government to break the inflation of 1965 were subject to criticism. AID/W noted that the GOT had chosen to draw down reserves and defer budget expenditures. The preferred way to eliminate an inflationary fiscal bias would have been to raise taxes, restrict credit and adopt more efficient budgeting procedures. Furthermore, the SEE Reorganization Committee set up earlier had just completed two years of study without resolving the basic problems facing the enterprises, most of which had to be subsidized by the central fisc. Finally, the cable noted that the GOT was dragging its heels on evaluating the existing foreign exchange system. Devaluation had become a leading item on the Mission agenda, and apparently AID/W felt the Turkish response was unsatisfactory. In short, while economic performance indicators were good, GOT self-help indicators were not. Apparently A.I.D. did not press these points. Even if it had, it might have found progress hard to make in a period, when Turkish performance, for whatever reasons, was relatively good.

F. FY 1967: $65 million

The FY 1967 loan was signed in March 1967 and released in tranches of $35 million (May) and $30 million (September). The significant phrases in the Preamble to the Agreement referred to (1) accelerating economic development, (2) maintaining price stability, and (3) increasing foreign exchange earnings. In another clause, the Preamble called attention to an expectation that other members of the Consortium would finance up to $45 million of program funds. Notably missing from the Preamble this year were references to import liberalization and/or devaluation. But a significant addition to the Agreement was language explicitly sanctioning a review to precede release of the second tranche, "to be made available from July 1, 1967 after a review of the extent to which the purposes of the loan and the events contemplated herein had been fulfilled."

As usual, conditions for release of the second tranche were made explicit during the negotiations. The emphasis was put on adherence to the IMF stabilization program (including ceilings on Central Bank credit to commercial banks, State Economic Enterprises, and the central budget), promotion of exports, and the Government's success in securing the $45 million. Import liberalization and devaluation were discussed, but since the IMF was reviewing these matters with the GOT A.I.D. deferred relating them to the loan. It made clear, however, that the next year's negotiations would bring them back into focus.

One related issue that received considerable attention was additionality. The U.S. wanted to ensure that the program loan would be matched by a nearly equivalent increase in American exports. This sort of condition is not of primary interest to our study, but it overlaps conditions that are, for example, the U. S. share of balance of payments assistance. It was also tied to import liberalization, for the elements of a program designed to encourage imports from America included many of those designed to encourage imports in general.

Performance measured by macroeconomic indicators was more than adequate to justify the tranche releases. Exports and worker remittances did very well -- the latter rising from $70 million in 1965 to $115 million in 1966 (though they fell off again in late 1966 and throughout 1967 as a result of the slow-down in West Europe). The tourist industry enjoyed an unprecedented boom. The rise in export earnings was offset by an even greater rise in imports, but even that had its welcome aspects. The GOT had permitted "quota" imports to increase 35%, which brought relief to many of the industries which had been working at less than full capacity because of a lack of equipment, parts and raw materials. Finally, prices had stabilized: the October 1966 level was 5% below the February high, and no notable increase occurred thereafter.

However, as measured against the announced targets for the second tranche, performance was less impressive. There was both good and bad news. IMF credit ceilings had been exceeded, but the economy was booming and IMF officials felt the additional liquidity was necessary. On the other hand, the Government had run a budget deficit and lost foreign exchange reserves. Moreover, the Consortium financing target had not been met. There was a shortfall of about

$10 million from the $45 million target, which provoked the U. S. Secretary of the Treasury to advise the President either to insist on very rigid additionality terms the next year or plan a much reduced loan, or else risk a continuing drain on the U. S. balance of payments. To the obvious displeasure of the Secretary, the second tranche was released more or less on schedule.

G. FY 1968: $40 million

Owing to the Agency-wide shortage of funds, DL program loan funds available to Turkey in FY 1968 were less than in past years. Negotiations were completed and the Agreement was signed in May 1968. There was only one tranche.

Even before the reduced appropiration was announced, the Mission recommended a reduction in order to induce action by the GOT to correct its own balance of payments problems. A subtle but significant change in the strategic approach to program lending had occurred. In the past, the level of program assistance had been based on what the balance of payments requirement was likely to be. In FY 68, the level was based on what the requirement should be assuming certain actions were taken. This was supported by the IMF, which was discussing overall policy reforms with the GOT. The willingness of the IMF and U. S., as well as other lenders to provide supplemental financing should the GOT take appropriate actions, was explicit in both dialogues. In addition, other lenders were supporting the lead being taken by the IMF by keeping a close rein on their assistance. This is evidenced by the EMA's decision to grant only a six-month roll over of its 1968 debt in order to maintain the pressure.

The FY 1969 Program Memorandum dated August 1967 spelled out two alternative assistance programs. Alternative A assumed no significant new self-help and a commensurately reduced loan level; alternative B assumed suitable GOT action on import liberalization, export promotion and devaluation and a higher loan level (necessitated in part by the projected increase in liberalized imports). Talk of aid conditioning was stronger than before. Success or failure in dealing with the principal issues -- including, in addition to those mentioned above, fiscal and monetary stability and a major assault on inefficiency in the Turkish industrial sector (both public and private) -- would be the "principal determinant of the U. S. response to Turkey's aid needs." The U. S. reaction to failure was plotted as a policy of great stringency and a minimum maintenance level of program aid (Alternative A).

By the Fall of 1967, the rhetoric of program loan leverage in Turkey was not unlike that in Latin America. The Mission stated that program lending gave it "extremely important" influence with the government on general policy matters, which "undoubtedly would be more difficult to obtain if project assistance were the exclusive channel for aid." The Mission intended to make the relationship between U. S. aid and Turkish accomplishment "as close as possible." The significant differences from the Latin American model were the absence of jointly signed statements and a formal mid-year review/tranche-release process, the Turkish June review being a relatively perfunctory exercise. But the pre-loan negotiations were supposed to accomplish the purposes of those mechanisms.

With only $40 million to offer, the U. S. negotiators had few degrees of freedom. (The $40 million figure was the floor identified by the LAS in 1963, below which the GOT could be expected to "reconsider" its political alignment.) Nevertheless, some reports on the negotiations say that more was accomplished than ever before. This refers in part to the additionality issue. But apparently the GOT wanted the $40 million, and was not opposed to the general economic outline set forth by the U. S. negotiators in February 1968. That included (1) adherence to the new IMF program, should there be one, and in any case responsible performance in the fiscal and monetary field; (2) adoption of measures to divert tourist spending of foreign exchange to the authorized market (almost one-half of tourist foreign exchange imports were being captured by non-official parties); (3) increased tax rebates on exports and (4) encouragement of other donors to increase their share of aid.

Significant omissions from the FY 1968 conditions were again liberalization and devaluation. The Turkish authorities were not yet agreed that devaluation was desirable and, without devaluation, there was little that could be done to achieve a more competitive import regime. Indeed the conclusion of a major A.I.D. in-house analysis of Turkish import policy was that the system, though inefficient, was not a significant explanatory factor of industrial backwardness. Conversely, A.I.D. could point to several key qualitative indicators which demonstrated that a significant increase had occurred in the priority attached by the GOT to export policy. For example, the State Planning Office had assumed responsibility for the administration of tax rebates on exports and started to clear the backlog of refund applications. Also, for the first time, the central budget had allocated funds that could be transferred to private enterprises for investment.

III. THE PRINCIPAL ISSUES

A. Did A.I.D. try to use the program loan to influence policy?

In FY 1963, under the influence of the increasing stress then being placed on self-help, the Mission tried to attach a formal conditioning procedure to its first program loan. Although the Turks were ready to talk with A.I.D. about their policies, they utterly rejected all efforts to get negotiated performance conditions. The most this experience could be said to have accomplished is that it established the legitimacy of frequent and far-ranging substantive reviews. But even this may well have existed already.

After its initial rebuff, the Mission seems to have gone through a period in which little attempt was made to use the program loan to influence policy. The inflationary spurt in 1965 and the thinking about an Assistance Completion Plan revived interest in use of the tool. Thus, the FY 1966 loan strenuously supported conditions in the IMF Standby Agreement and went beyond them in some cases. The FY 1967 pattern was similar.

By FY 1968 the aid level was falling, bringing pressure on the GOT to do something about its persistent foreign payments deficit. At the same time, high-level staff changes in USAID/Ankara happened to lead to increased interest in aid conditioning. As a result, discussions during the 1968 negotiating sessions were probably more comprehensive, franker, and based on better underlying staff work than ever before. Turkey's dominating foreign exchange problem and possible devaluation, import liberalization, and export promotion measures to solve it, featured more prominently than in the past. The FY 1968 loan is formally conditioned on some (though by no means all) of the policies discussed.

B. Did Turkey perform?

The performance of the Turkish economy since 1960 has been impressive. GNP growth has averaged 5.4% a year at constant prices. GNP per capita went from $250 to more than $300 in just five years, 1962-67. Gross investment has risen to 18.5% of GNP. Growth in agricultural output has averaged nearly 5% per annum (since 1962), growth in industrial production nearly 10%. Receipts from commodity exports, invisibles, and remittances have grown impressively.

Interpretations of this favorable growth experience vary. As already noted, many observers feel that although the GOT's management has definitely improved since 1960 the favorable performance is heavily dependent on fortuitous circumstances (especially Turkey's location, which allowed it to cash in on the West European labor shortage and tourism boom) and heavy foreign aid. Assessments on Turkish self-help also differ. A.I.D. has been generally agreeable to GOT policies in the 1960's, but few would term Turkey outstanding in self-help. A crucial question is whether the growth pattern is viable, whether Turkey can go on as it has (though with reduced aid) without adjusting its long-stable and obviously overvalued exchange rate and opening up its highly protected state and private industries to foreign competition. It is those who think it cannot who are most likely to be critical of GOT self-help todate and most likely to favor tightened aid conditioning.

One can point to many self-help actions which the GOT has taken. In a country with an inflationary history, it has run a sound monetary and fiscal policy. It has planned and managed its development activities with reasonable effectiveness. Its shortcomings (from the U. S. point of view) are no doubt explained largely by Turkey's culture and history. All Turkish Governments have distrusted foreign investment and trade, as well as the private sector (long dominated by the Greek and Armenian minorities) in general. Yet, recently the GOT has even begun to show signs of movement in some of its former bastions of inactivity (e.g. the broad export incentives announced recently). Thus while the self-help record lacks the glitter of the performance record it is far from bleak.

C. Did A.I.D. influence policy?

As has been seen, A.I.D. influence in Turkey has been limited by traditional Turkish antipathy to seeming foreign domination, by the importance of U. S. objectives other than development, and by the fact that Turkey's economic growth -- sustainable or not -- has been rapid. In the foregoing chronological account, there is little evidence that program aid was ever really conditioned on Turkish performance. No aid was withheld or significantly delayed for reasons of non-performance, and one gets the impression that such action was never seriously considered. However, this does not necessarily mean that A.I.D. had no influence. Nor would it necessarily have had more influence if it had conditioned aid.

We have seen evidence that influence on Turkish policies was exerted through at least four other channels. Any or all of these may have been more important means of exerting influence than the program loan, at least until very recently.

The Consortium. As compared with the India and Pakistan consortia, the Turkey Consortium has been a weak tool of influence. For one thing, it was originally formed primarily as a means of increasing other donor contributions and multilateralizing aid to Turkey in general. Thus, it has been headed by a German and backstopped by the OECD in Paris. Its head has been less interested in policy than the IBRD consortium heads, and he has had a far weaker staff behind him. Yet the present head is more interested than his predecessor, and has proved to be the most effective means of suggesting policies in the foreign exchange field in particular. If accelerated declines in U. S. aid do not undermine it, one can expect more from the Consortium in the future.

The IMF. IMF advice has been very well received in Turkey, and the U. S. has done well in achieving its monetary and fiscal policy ends simply by standing behind the Fund. When it became necessary in 1966, this stance was reinforced through explicit use of the program loan negotiations.

Capital projects. Unlike most of the major program loan countries, the Turkey program has retained a large capital project component. Previous USAID administrations have asserted that they derived much of their policy influence by conditioning this form of aid. Thus, a copper smelter project was said to have been used to influence the allocation of industries between the private and public sectors, a coal project to get cost-covering pricing in a nationalized industry, and a power project to prompt a general survey pointing toward possible reorganization of the industry. We have not examined these claims in detail, but it seems obvious that any influence the projects conferred must have been narrow in scope at best.

The continuing dialogue. Finally, veterans of the Turkey Mission, like all other Missions we have studied, emphasize that much is achieved informally through day-to-day contacts with the host government. One former Director of USAID/Turkey is said never to have participated in program loan negotiations, but to have exerted his influence in periodic meetings with various Ministers. This kind of dialogue goes on everywhere and it is impossible for us to tell whether it is more effective one place than another. Probably this depends on the energy and ability of the Mission staff, plus the receptivity of influential people in the host government.

D. Can A.I.D.'s influence be attributed to the program loan?

Relative to most (perhaps all) the other countries in our study, program lending to Turkey has been little conditioned on the nature of host country policies. Even attempts to influence policy without aid conditioning (i.e. through persuasion) have been carried out through several channels, of which program lending is probably not the most important. U. S. influence is less clearly attributable to program lending than it is in other major country programs.

To see whether the program loan should be accorded any importance at all, one must ask whether the same aid level, managed in the same way except made up entirely of projects, would have obtained the same results. It is probable that it would not. One USAID/Ankara official commented that "project aid tends to consume its own leverage," leaving little room for influence on general policy matters. This is somewhat exaggerated, however, as the size of the projects program and the examples cited earlier of influence derived therefrom suggest. Also, several technical assistance projects were aimed directly at those institutional bottlenecks -- in export promotion, industrial reorganization and planning -- upon which the program loan negotiations were focused. But even though the leverage attributable to the sum of the parts of the A.I.D. program was larger than that due to the program loan alone, the entrée to discussions of stabilization and trade policy must be attributed primarily to the latter. In other words, if we shifted from program to project loans, we might lose those entrance tickets. It is interesting to note that this is also they conclusion of the FY 1969 PM, which tried to answer the same question.

IV. DETERMINANTS OF INFLUENCE

A. The conditioning system

1. Explicitness and specificity of conditions. We have argued that program lending in Turkey has been policy-conditioned only in a very general sense. Certainly there has been little or no conditioning of a highly explicit or specific nature.

As we have seen, the Turks have steadfastly resisted explicit aid conditioning. Since 1963, they have refused to sign any agreement or side letter containing a commitment on economic policy. Their exceptionally strong feelings on this subject are attributed by many observors to cultural and political factors, not excluding the legacy of the 1962 purges, when officials of the Menderes regime were condemned for having made similar commitments without parliamentary approval. It is hard to accept that the Turks are really that exceptional. One wonders whether the Mission did not overreact to its 1963 experience and became excessively reluctant to press conditions in later years. After all, the GOT agreed to the IMF's stabilization conditions, and to military covenants with NATO (though we are told that these are more acceptable in Turkey).

Nevertheless, there is no evidence that the absence of written commitments made a significant difference. Memduh Aytur claimed in 1963 that the GOT was prepared to consult informally on any subject and even open its books to A.I.D. His only objection was to having to confirm that offer in writing. Mission officials from this and later periods seem to agree that the written commitment was immaterial. They say their access to Turkish officials and influence on them was not affected by the absence of such documentation.

The specificity of aid conditioning in Turkey has been low relative to the other countries we have studied. Program lending has been conditioned primarily on the broad acceptability of Turkish policy, including amicable relations with the IMF. Only with the FY 1966 loan does A.I.D. appear to have developed a more particularized view of what the GOT would have to do to remain aidworthy. Even with the FY 1968 loan, however, the degree of specificity remains relatively low; it does not encompass quantitative targets or dated administrative or legislative actions, for example.

2. Enforcement. Performance reviews prior to second tranche releases, in years when they occurred, appear to have been perfunctory. Neither with a tranche nor with a new loan was there ever any indication that money might be held up for reasons of nonperformance. Defenders of the Turkey program argue that such action was ever merited. Certainly the impressive overall performance of the Turkish economy made it difficult to claim that self-help was seriously deficient. And, given the general nature of those performance conditions which were defined, it is probably true that enforcement cannot be considered a weak link in the conditioning system.

3. Number of conditions. The number of loan conditions has consistently been kept low. While many subjects -- including sectoral development policies -- have been discussed in the loan negotiations, only three or four were cited in the Preamble to the Agreement and later reviewed in relation to the second tranche or the next year's loan.

.. Areas in which conditions were specified. To the extent that program aid can be said to have been conditionted at all, it has been conditioned on solution of the structural imbalance of Turkey's external trade and payments, on monetary and fiscal stability, on increased incentives for domestic and foreign private investment, and on rationalization of the State Economic Enterprises. Results in the monetary-fiscal area appears to have been very good. In the balance of payments field, probably the most important for future development, significant individual actions have been taken, but the basic problem and the need for further policy changes remain. On questions of foreign private investment, the dividing line between the private and public sectors, and organization of public industries, U. S. influence seems to run into strong ideological barriers. In these areas, attempts to change policy through tough use of leverage would probably fail. A better, though slower, tactic is to educate the Turks and gradually lead them toward a more pragmatic, less doctrinaire approach to development.

5. Dissipation through time. There is no evidence of dissipation; on the contrary, the recent move of the GOT off dead centers on export promotion policy argues the other way. But the U. S. has only recently started to tighten its conditioning of aid, so Turkey really provides no evidence on the dissipation hypothesis.

B. The Loan

1. Loan Size. Loan size remained roughly constant through FY 1965. It slipped in fiscal year 1967, but only in FY 1968 did it fall really sharply. Historically, this drop in aid level seems to correlate with increasing rather than decreasing influence (contrary to the prediction in the LAS). Of course, a lot of other factors were changing at the same time (notably the degree of Mission interest in conditioning aid), and it may be naive to relate the increased influence to the reduced aid. An alternate formulation is that being able to provide more aid than the recipient expects (fears?) he will get confers leverage, even with a declining absolute aid level. FY 68 may be no exception. Although it appears that the various changes in the trade policy area taken by Turkey since then are due to negative leverage, the apparent threat to the GOT at the negotiations was that, failing reform, it would get even less.

2. Direction of change in loan size. As just noted, the period includes a declinig aid phase. It does not cover a phase of increasing aid. However, Turkish experience is consistent with the view that influence can be wrung from a declining as well as a rising volume of aid.

C. Environmental influences

1. International politics. The Turkish politico-military role in the Western alliance has dominated the program loan experience. It either drastically reduced the credibility of the self-help conditioning process or intimated the principal U. S. negotiators into thinking it did. Which was it? Although the Turks argued that they "paid" for U. S. aid with their bases and divisions, the alliance has also had sizeable benefits in terms of Turkish national interest, and traditional Turkish conceptions of it. Moreover, other countries (e.g. Korea, Pakistan up to the early 1960's) which have been in a similar position have proven to be highly favorable testing grounds for conditioned aid. We conclude that despite superficial appearances to the contrary Turkey's nondevelopment relations with the U.S. did not rule out aid conditioning.

2. Domestic politics. Until Demirel won an absolute majority for the Justice Party in the parliamentary elections in October 1965, program loan negotiations were conducted under the unsettled conditions of the second, third and fourth coalitions. The first two of these were controlled by the RPP, the third by the JP. The FY 1963 negotiations had also been played out under the shadow of the execution of Menderes in late 1962. The effects of political instability may go a long way in explaining the reluctance of GOT officials to make a commitment to a foreign government, an act which must have appeared to many among them as political (or even personal) suicide.

3. Multilateralism. Two institutions should be separately discussed. First, the IMF played a major role in helping the GOT preserve monetary and fiscal stability, and more recently, in reviewing trade and exchange policy. It is possible that U. S. influence in the 1950's was primarily responsible for setting IMF up on such a good footing. It is certain that the IMF representatives communicated with Mission personnel on important matters, and that U. S. support of the IMF stand-by programs greatly fortified the IMF position. Nevertheless it is also clear that since 1963 the IMF played its part essentially independent of the Mission, and must be given substantial credit for the success of stabilization policies. As mentioned above this success in effect preempted the easiest field of economic policies, forcing USAID to use whatever influence it had on structural problems. As mentioned elsewhere above, the IMF experience also introduced the formal quantitative targeting process to Turkey ... breaking the ice so to speak for eventual U. S. use of similar targets.

The other institution is the Consortium. The Turkey Consortium staff at OECD headquarters in Paris merely manages the thrice-yearly meetings. It does not attempt to identify problem areas in economic policy and prescribe solutions, as the IBRD staff does for its consortia and consultative groups. The Consortium as a deliberating group of donors never played a dominant role in exacting self-help performance from the Turks, except with respect to monetary and fiscal policy. The U. S. was consistently the initiator of any attempts at leverage the Consortium may have made. Other bilateral donors, for example Germany, have not felt that self-help conditions were needed, let alone practicable. (To some extent, both Germany and the German head of the Consortium now seem to be changing their positions)

D. Personal touches

As in other Missions, one senses variations from time to time in the approach, attitudes, and calibre of Mission leadership and policy staff. It is very hard to tell how much importance to attribute to these variations. Anxiousness to influence GOT policy and volume and quality of staff-work upon which to base recommendations seem to be at an all-time high at present. In time, it should be possible to see whether this will make any significant difference.

V. CONCLUSIONS

The general outlines of the Turkish experience are clear, though some unsettled questions remain. Turkish economic performance has been well above average, though not up to that of the very best aid-receiving countries. Turkish policy has also been generally acceptable to the U. S., with the increasingly important exception of the balance of payments -- exchange rate problem (although there are now signs of GOT movement in this area as well). Program aid generally has not been performance-conditioned, except in the broad sense that the acceptable overall policy lines be continued. Certainly formal conditioning has been slight. U. S. influence seems to have been exerted in an environment in which the volume of aid was only tenuously related to whether the advice was followed.

The questions which remain are how great U. S. influence has been under these circumstances and whether it would have been greater if aid had been more conditioned (using one or another of the conditioning systems applied elsewhere in the world). On the basis of our study, we find these questions difficult to answer. Yet we cannot ignore them completely. We must therefore say that we come away from the study with the feeling that U. S. influence on GOT policy (through all channels) has been less than in most of the other countries in our sample, and certainly low relative to the large volume of U. S. aid Turkey has received. We are also convinced that this influence would have been greater if the GOT had been made to believe that the volume of aid they received depended in part on their self-help performance. We feel this thought could have been conveyed without encountering the dilemma of whether to stop aid to Turkey altogether when performance was inadequate, through the use of delaying tactics and marginal adjustments in the aid level (though U. S. unwillingness to permit any break in aid relations with Turkey would undoubtedly have reduced U. S. influence).

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TUNISIA

by

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PROGRAM LOAN STUDY: TUNISIA

I. INTRODUCTION

Program loans were introduced in Tunisia in FY 62. They replaced the six year old non-project grant program. They came in at a level one-half as large as the grant program, and have remained at about that level, without missing a year, ever since. The Mission has now negotiated the seventh loan in the series, making the program one of the oldest in A.I.D.

It took several years for both the Mission and the GOT to accept the fact that the ground rules for non-project support had changed, and that the negotiators would have to tie the loan to self-help performance. Starting with the FY 64 loan, however, conditions were loosely applied to the loan and annual reviews were instituted to discuss past performances and future plans.

The conditioning system was substantially strengthened in late 1964 when the IMF made the first Stand-by Agreement with the GOT, and wrote out an explicit set of criteria for the GOT to meet. It was buttressed again in late 1965 when the previously dormant IBRD Consultative Group instituted a formal review based on an annual IBRD staff report and the GOT's Annual Economic Budget.

In FY 66, the U. S. moved to a formal tranche review system of its own, where explicit conditions were included in the loan agreement and half of the loan was delayed pending progress toward meeting them. Most of the U. S. conditions repeated IMF conditions. Some, however, were tougher than the IMF conditions. Some were not.

The U. S. never attempted to establish a credible position with respect to the ultimate instrument of leverage -- the threat of withholding or reducing the loan. In fact in each intra-agency debate over negotiation strategy since FY 62, AID/W tended to adopt the position that, with or without GOT performance, A.I.D. was drawing the program-loan program to a close, and that the GOT ought to start looking to Western Europe to fill its need for program aid. Further, A.I.D. did not try to fit the level of the loan to performance, or delay the second tranches. At the most, A.I.D. prolonged the annual negotiations till GOT had agreed to meet A.I.D.'s minimum terms.

Nevertheless, A.I.D. seems to have exerted a good deal of influence on stabilization policy in Tunisia. With the exception of 1964 and 1966, when devaluation and a bad harvest respectively interfered with the orderly working of the Tunisian economy, fiscal, monetary and credit indicators performed relatively well (compared to most LDC's). This was due to the rigid controls established by the GOT and its willingness to make sacrifices in order to preserve domestic stability. President Bourguiba's administration is not intemperate, and would have tried to control inflationary pressure as best it could in any case. The U. S. presence, however, and the program loan negotiations in particular, appear to have induced a more prudent response than would otherwise have occurred. The U. S. could not have done as well without the IMF constraints though the dominant day-to-day influence was the American.

The unusual thing about the U.S.-Tunisian program loan leverage experience is that it can be judged relatively successful even though it failed to achieve the two most frequently articulated targets. As early as FY 64 A.I.D. made clear that these were (1) having the GOT find another donor of last resort and (2) having the GOT reestablish viability on the current account. The only other logical donor was France. Since Tunisia continued to expropriate bits and pieces of the residual colonial portfolio, the French were not prepared to be generous. The viability issue was equally intractable. Tunisian "invisible" earnings disappeared with the reduction of the Bizerte naval base. Her traditional exports depended mainly on preferential or stagnating markets and there had been no increase in these exports since the late 1950's. At the same time, like most settled ex-colonies, Tunisia inherited a high propensity to import. Moreover, President Bourguiba had initiated an ambitious, popular and successful public investment program with a heavy import content. Foreign exchange reserves were caught in the squeeze between falling earnings and rising imports due to greatly expanded investment. They declined 66% between 1960 and 1964, leaving Tunisia with foreign exchange sufficient to cover only three weeks of imports.

The U. S. and IMF conditions were intended ultimately to tailor imports to earnings. For the reasons just mentioned this was an impossible job to accomplish quickly. It was a grim prescription for President Bourguiba, who had committed his Party and himself to his social welfare programs. It was an uncomfortable position for A.I.D., since those programs conformed in every respect to the usual self-help development indicators and in any case the increase in imports attributable to the development programs was modest judged by world-wide standards. Tourism is the big growth export; A.I.D. supported its expansion verbally, but could not provide financial assistance. The current account has not really righted itself yet, although, with surprisingly little encouragement from A.I.D., exports have begun to move smartly in the last two years.

II. CHRONOLOGICAL SUMMARY

A. Summary of U.S. and Other Donor Aid

When Tunisia became a republic in 1957, the flow of public and private French capital to the former colony tapered off. The United States Government thereafter assumed the role of major donor and has kept it for ten years. The U. S. has been trying to give up that role during the last five years, and has managed in that time to assemble a Consultative Group of other donors under the aegis of IBRD. But Tunisia's relationships with her principal creditors -- France and Italy -- have suffered from her increasingly tough position on the rights of expatriates of those countries to retain property in Tunisia, and the Consultative Group has never developed into the sympathetic and generous protector the U. S. had hoped to create. The U. S. insists it will cut off program aid in the next year or so, and all concessional assistance shortly thereafter. Tunisia's precarious balance of payments seems unlikely to improve in that time, however, and there is some question whether, without a major shift in France's aid policy, the U. S. will be able to withdraw without altogether disrupting Tunisia's fairly successful development performance.

The U. S. program in Tunisia started in FY 57 with SA grants of $5 million for balance of payments support. The SA grant program grew rapidly. It averaged $20 million per annum in the period FY 59-61, and it was higher in FY 62 than ever before ($22 million). The bulk took the form of a cash grant. The rest comprised triangular trade arrangements. Then, conforming with A.I.D.'s new emphasis on loans, SA grants fell as precipitously as they had risen: to $13 million in FY 62 and zero in FY 63.

They were replaced by DL program loans. These have continued annually since FY 62 at a level of $10 to $15 million. A.I.D.'s FY 68 loan for $10 million, the seventh in the series, was signed in Tunis in June 1968.

Project lending began in FY 58. It has averaged about $9 million per annum over the last ten years, but has been substantially lower than that average during the last three (FY 65 $6.8 million, FY 66 zero, FY 67 $6.7 million).

In dollar terms the most important component of the U. S. program, at least since the phase-out of SA grants, has been PL-480. This has consisted of two elements, a Title I wheat program whose size has fluctuated according to Tunisia's annual grain crop (and reached a high of $22 million in FY 67), and a major Title II Food for Work Program (which was recently cut, then restored). As discussed in Section III.C the Mission refers to PL-480 as its "other" major instrument for gaining leverage on the GOT's economic program.

In addition to these capital and commodity flows, a technical assistance effort has been maintained since the inception of the U.S. program. U. S. dollar obligations on technical assistance have varied between $1 and $2 million, and these funds have been augmented by dinars from the PL 480 counterpart accounts.

Chart 1 shows the relative size of these component parts of the overall U. S. program. Notice particularly the <u>fall</u> in non-project support as the Mission shifted from SA to DL appropriations:

<u>Ten Years of U. S. Aid to Tunisia, FY 57-67</u>
(Net Dollar Loan Authorizations and Grants - millions)

<u>FISCAL YEAR</u>

	1957	1958	1959	1960	1961	1962	1963	1964	1965	1966	1967
Loans											
Project	-	4.3	4.4	23.5	10.0	2.4	8.3	10.2	6.8	-	6.7
Program	-	-	-	-	-	10.0	15.0	10.0	10.0	15.0	14.8
Grants											
DS/SA	76.0	15.3	21.5	22.2	24.8	5.3	-	-	-	-	-
DG/TC					2.0	10.5*/	1.1	0.4	1.1	2.0	2.1
PL 480											
Title I	-	-	-	-	11.4	4.5	10.6	3.8	13.2	-	22.4
Title II	-	6.6	7.2	11.5	57.8	12.2	23.9	18.4	21.2	1.7	7.7

*/ Around $8 million DG funds were used for commodity imports.

Program loans of $10 to $15 million cover 5% of Tunisian's total imports, a relatively small share compared to the other programloan countries where the share varies from 10% to 16%. Presumably the share size should influence leverage, since the smaller the share the less one would expect the recipient government to be pushed to the hard decisions it otherwise would have avoided. The evidence indicates otherwise, that in fact the U. S. leverage exercise has been no less successful than elsewhere. In per capita terms, program loans of $10 or $15 million are not out of line with the other program loan countries. They are less than in Latin America, and higher than in NESA.

French aid has been erratic since 1957. Technical assistance (particularly school teachers) has continued without interruption at a level valued at an estimated $10 million per annum. But the various channels of official French capital aid -- loans, debt roll-overs, and protected markets for Tunisian wine and wheat -- have frequently been closed in retaliation for nationalization of French farms and commercial property in the ex-colony. For example, official French annual loan disbursements during the period 1960-66 are estimated consecutively, at (in $millions): 0, 0, 1.6, 12.2, 3.9, 0, 0. In the last two years, however, the French have joined the Italians and Germans in trying to develop some framework for cooperating with the Tunisians in financing the now perennial deficit on current account. Total non-U.S. bilateral aid, including French, has grown steadily to its present level of $50-60 million from about $25 million in 1961.

The IBRD plays a double role in Tunisia, as chairman of the Consultative Group and as a donor in its own right. The CG was formed in 1962 in response to a GOT request, (though the U. S. was the prime mover in the operation). It includes each of the major West European donors plus Kuwait, Canada, the U.S., and the IMF. It was weakened after 1963 by the French walk-out, but since late 1965 has regrouped and taken a stronger role. The group calls for an annual review of GOT economic policies. The IBRD serves as secretariat to the CG. It prepares a situation report for the annual review session, recommends modifications in the proposed budget and economic policies, and suggests to the CG an aid level target. (Since this is a Consultative Group, not a Consortium, pledges are not made.) To demonstrate its favorable impression of GOT economic policy and the state of health of the Tunisian economy, the IBRD pledged $100 million in December 1965 to the Tunisia Four Year Plan (1965-68). Seventy-five million dollars of that now has been obligated, a significant share for local costs.

The IMF has played a major role in Tunisia's stabilization policy since 1964, when the deterioration of foreign exchange reserves assumed crisis proportions and the first Stand-by Agreement was signed (October 1, 1964). The Stand-by has been renewed each year thereafter. Conforming to usual IMF posture, the Agreements impose conditions on GOT policy, with quantitative targets to measure performance. At first the IMF conditions were limited to credit policy, but have since been extended to the GOT budget and export and import programs. During the early 1960's the U. S. had insisted on an IMF role in Tunisia's stabilization policy, and has since strongly supported, and coordinated its own conditions, with the IMF program.

In general, Tunisia's economic performance in the early years after independence was comparatively good. She continued France's colonial investment program and, in 1960, initiated a major national planning exercise. Fiscal and monetary policies were conservative: the budget remained balanced, prices remained stable. There was no significant domestic or foreign debt, and foreign exchange reserves rose steadily through 1959, holding steady in 1960. Undoubtedly this good record influenced U. S. decisions on the overall aid program.

There was no attempt to condition the level of that program -- or of the SA commodity import component -- on performance criteria. Those levels were determined on the basis of the projected balance of payments gap, and political factors. Nevertheless, the U. S. enjoyed substantial influence with the GOT, for example it shared with France the credit for getting the Tunisians started on the planning exercise.

B. FY 62: $10 million (DL Loan #011)

A.I.D. authorized a $10 million loan in May, 1962, to complete the commodity import assistance program for FY 62. Already $13 million of SA (and DG dollar grants) had been obligated. The Agreement was not signed until November, and disbursements did not begin before October 1963, a year later. These delays were due to unexpected procedural problems, particularly one of developing a list of acceptable imports as required under the new procurement source restrictions of the DL authorization. Since U.S. exporters (including PL 480) then claimed only a tiny fraction (3%) of Tunisia's import market, additionality was more or less ensured if American products could be identified for import. West Europeans monopolized the trade in equipment, so the problem was either to find raw materials and other non-equipment goods of U. S. brand suitable to the Tunisians, or to reorient Tunisia's existing trade patterns. Both proved difficult, and this difficulty is one of the important explanatory factors in understanding the constant $15 million ceiling on the annual allotment, and the protracted haggling that frequently characterized the negotiating sessions.

There were no economic conditions written into the loan agreement. Nor were there any side agreements related to the program loan. However, conditioning language had already appeared at this time in GOT-A.I.D. discussions on the U. S. long-term commitment.

During his visit to the U. S. in May 1961, President Bourguiba discussed the possibility of long-term aid to Tunisia's draft Ten Year Plan (Perspective). This was followed by several AID/W visits to the field to examine the proposal in detail, and in December, 1961, the Patterson Mission recommended a long-term aid commitment of around $180 million. A U. S. obligation of $180 million for the period 1963-65 was under consideration in A.I.D. in the Spring of 1962, i.e. at the time the first program loan was authorized. This figure represented 50% of what USAID had estimated would be the foreign exchange requirements of the Three Year Plan (TYP).* In discussions before and during the visit to Washington of Ben Salah, the Tunisian Minister of Finance and of the Plan, in February, 1962, the GOT agreed to some general conditions for a major long-term commitment of DL funds. These included (1) avoiding inflation, (2) protecting the level of foreign exchange reserves and (3) periodic joint reviews of programs under the TYP.

The other reason for the appearance of conditioning language in GOT-AID discussions was the sudden deterioration in Tunisia's foreign accounts. The high rate of public investments since Independence, which the Perspective and the draft TYP planned to increase even further, but half of which was composed of work relief programs and social infrastructure projects (e.g., housing),

*The Perspective Decennale de Development 1962-71 was first presented in draft in August 1961, but specific investment proposals for the next three years were discussed in the Three Year Plan 1962-64, approved by the National Assembly in May 1962. USAID's opinion was that it would take four years to reach the TYP targets, which made the FY 1963-65 U.S. commitment compatible with the time frame of the official TYP, (although the commitment referred to obligations and the TYP expenditure).

had resulted in higher import levels, with no commensurate increase in exports. Tunisia sustained a $20 million loss of foreign reserves in 1961, from $97 to $77 million. The Mission warned that the ambitious investment targets of the TYP would lead to a continuing decline in reserves, and an equally predictable surge in domestic prices. It felt that any long-term U. S. commitment should be made contingent upon the GOT taking adequate steps to avoid these blows.

C. FY 63: $15 million (DL Loan #014)

In October, 1962, A.I.D. formally committed the $180 million package agreed to in February for the three year program. Specifics were to be spelled out in individual loan discussions. A memo to the GOT in December 1962 indicated the U. S. was prepared to entertain a request for a non-project loan for FY 63 of $10-$15 million. The loan was not authorized until May, 1963 -- five months later. It was signed in June 1963, but disbursements didn't begin until June 1964. These delays were due to U. S. concern for the overloaded pipeline (no FY 62 loan disbursements were made before October, 1963), arising from source procurement problems; these unexpected delays posed serious financing problems for GOT and weakened the U. S. leverage position. After long bargaining A.I.D. allowed Tunisia to include barter arrangements for $8.5 million of petroleum products of non-U. S. origin. No economic policy conditions were written into or attached to the loan and for all practical purposes the level and the timing of the release of the loan were divorced from economic policy considerations other than those specified by the TYP and the 3-year A.I.D. commitment.

In fact, A.I.D.'s internal debates edged towards a gradual shift entirely to project loans with program loans being phased out by a $5 million annual decrease in the loan level. U. S. procurement problems contributed to this shift in strategy. A.I.D. emphasized to the GOT that the latter's natural trading partners in West Europe were the appropriate sources for non-project aid. Unfortunately, A.I.D. got little support from Western European donors. The GOT tried hard to obtain program aid from non-U.S. sources and did secure about $10 million per year. All, according to one memo to the A.I.D. Administrator, were having trouble accepting the fact of a major U. S. policy change away from the past pattern of untied aid. The annual CAP narratives bear evidence that the Mission itself with good reason did not seriously consider the possibility of dropping program loans after FY 63. Nevertheless, there was apparently widespread agreement in A.I.D. that non-project assistance should play a diminishing role in the Tunisian program, assuming that Tunisia's proven needs could be met from other sources.

Given this shift, it is unlikely that the Mission considered the program loan the main vehicle for applying leverage, leverage it expected to derive from the $180 million commitment. Letters had been exchanged at the time of the commitment in October 1962. In one of them, the GOT agreed to four specific conditions: to maintain sufficient foreign exchange reserves, to pursue monetary and fiscal policies consistent with economic growth without inflation, to integrate all public investments, including work relief projects, into the central capital budget, and to arrange with the U. S. for periodic reviews of progress under the TYP.

A.I.D. hoped with these conditions and review sessions to impart a sense of urgency to the GOT over the continued deterioration of domestic and foreign balances. To the surprise of the Mission, Tunisia had almost hit the "ambitious" investment target scheduled for 1962, a 31% increase over 1961. But it did so at the expense of substantial increases in borrowings from the Central Bank and the first signs of inflationary pressure on prices. Worse, the deficit on current account of the balance of payment was $20 million higher in 1962 than 1961, and total reserves in December 1962 were down to $68 million (reflecting not only the pressure of investments on imports, but large irreversible losses of foreign exchange earnings from the French base at Bizerte and the Algerian rebel headquarters staff). Thus the stability conditions informally agreed in early 1962 had gone by largely unobserved. A.I.D. insisted the GOT take them more seriously in the future.

The FY 65 CAP submitted in July 63 identifies a long list of subsidiary reforms and initiatives which the Mission apparently discussed with Tunisian authorities. Most concerned the restoration of stability: deferring low priority investments, discouragement of non-essential imports, tourist promotion and the like. Others, however, were growth oriented. These included those calling for development of (1) water resources, (2) manpower resources, (3) agricultural output and (4) capital infrastructure, which the CAP identified as A.I.D.'s four major program goals. A.I.D. was obviously caught in a difficult position. On the one hand it expected the GOT to cut back on its investment plans, on the other it encouraged investment in selected areas of the economy. Stabilization and development policies can conflict in the short run, nevertheless several sections of the CAP suggest that the USAID intended to use the "limited" amount of leverage remaining under the $180 million program loan commitment and the joint reviews to press for improvements on both fronts.

D. FY 64: $10 million (DL Loan #019)

The FY 64 loan was authorized in April 1964 and signed in June. The Agreement itself included no explicit economic conditions. Standard conditions dealing with verification were met in October of the same year and disbursements started the next day.

Such unusually expeditious handling of the loan belies two important features of the FY 64 loan operation. First, it involved for the first time in program loan negotiations a side letter from the GOT agreeing to certain conditions. Second, it was 33% below the previous year's level and was clearly considered an "interim" measure by A.I.D.

Tunisia's domestic and foreign balance had again deteriorated in 1963. Though physical progress under the Plan was impressive, the consequences for the budget, prices and foreign exchange reserves were in line with the predictions of the Mission. Public borrowing jumped from $28 million in 1962 to $72 million in 1963. Wholesale prices rose 5.3%, forcing the GOT to institute tough controls on retail prices and wages and apply strict import quotas. Then, shortly after AID/W authorized the FY 64 loan, the GOT nationalized the last of the French farms and the French retaliated by terminating all financial aid to Tunisia.

In view of these developments, A.I.D. delayed notifying the GOT of the authorization action, and instead insisted that the GOT first agree in writing to make a determined effort to bring investment and the foreign balances back into line. Specifically, A.I.D. required assurances of GOT willingness to draw up a program to improve its balance of payments and to seek additional non-U.S. aid of a program type. Moreover, A.I.D. asked the GOT to agree to request assistance from the IBRD staff in drawing up such a program in advance of the Consultative Group meeting in the Fall of 1964. Among the corrective measures suggested by A.I.D. were the ones emphasized the previous year plus recommendations for devaluation (at the "appropriate" moment) and the possible use of IMF credit.

Ben Salah, the Minister of Finance and the Plan, honored this request in May 1964 by sending letters to both USAID and IBRD bearing an outline for corrective action and asking for IBRD services in filling it. These letters satisfied A.I.D. The U. S. indicated, however, that the question of future program assistance to Tunisia would be considered "in the light of the program adopted, the views of the IBRD staff, and the position taken by other donors."

It is difficult to determine the relative importance of the factors which could explain the fall in the program loan funding level in FY 64 from $15 million to $10 million. Documentary evidence suggests A.I.D. was intending to carry on at the $10-$15 level for at least another year, and the discussions with Ben Salah point in the same direction. On the other hand, the procurement problem had not eased, and combined with the pipeline the $10 million level more nearly approximated the maximum conceivable level of transferrable resources of approved origin within the period covered in the economic justification. Finally, it was obvious that GOT performance had not met even the loose standards established by A.I.D. in 1962 and 1963, and presumably to reflect nonperformance the level of lending had to be cut. Of the three factors, the last played a relatively minor role. In other words, though A.I.D. was gradually tightening the conditioning process, it wasn't applying penalties for nonperformance.

E. <u>FY 65: $10 million (DL Loan #024)</u>

The FY 65 program loan was authorized in June 1965, signed in July, and disbursed starting in November. No economic conditions were written into the Agreement or in side letters. As in FY 64, the loan was referred to as an "interim" measure to help the GOT finance the annual deficit and not necessarily indicative of the level of future program loans.

A.I.D. policy on program loans to Tunisia had shifted again during the preceding year. The final LAS report of January 1965 set the stage. It recommended that A.I.D. give up the hope of transferring the burden of principal donor to West Europe. Rather, in its effort to bring an early end to concessional aid to Tunisia, A.I.D. should encourage wherever possible improved performance on the part of the Tunisian's themselves. Meanwhile the $180 million commitment was moving very slowly, causing GOT officials to blame the U. S. for their troubles. In fact, only about $100 million was obligated during FY 1963-65. LAS considered the overall aid level to be the source of general leverage, but focused on the program loan as the principle instrument available to the U. S. "to influence those general policies upon which optimum growth depends." The principal author, a consultant from outside AID/W, suggested that a minimum level of program loan aid be identified conforming to overriding political considerations and absolute economic necessity, but that the annual loan should vary above that within an incentive range "in which incremental assistance above minimal needs would be provided on the basis of commendable self-help undertakings." An annual level of $30 million -- far above previous estimates -- was suggested as the maximum figure consistent with the possibilities for direct procurement and barter arrangements within U. S. regulations.

The LAS report also tried to define the boundaries of the leverage operation. It reiterated the major policies where further action was desirable. It warned, however, that certain subjects were particularly sensitive (e.g., the role of foreign private capital and the desirability of social welfare investments) and that the U. S. could not expect to exert much influence over GOT policies in those areas. It also warned against over-indulgence in quantitative indicators. While accepting that some budget and credit performance criteria were susceptable to precise measurement, the LAS pointed out that the most important actions were long range and impossible to measure against specific tests. Nevertheless, annual negotiations based on reviews of past performance and the proposed budget were called for, and specific guidelines for policy reform were set forth.

Documents of the same age as the LAS show that Mission planning conformed generally to the LAS strategy. The GOT had promised to prepare an Annual Economic Budget for 1966 (AEB) and to make it available for a Fall 1965 review with A.I.D. and the Consultative Group. It was the prospect of a full review of 1966 budget plans that persuaded the Mission and AID/W to push through an "interim" measure for FY 65 (addressed largely to CY 1965 delivery needs) devoid of specific conditioning language and targets outside of those defined by the IMF standby.

Other important developments accompanied the redefinition of A.I.D. policy. In September, 1964, after suffering further losses in foreign resources (by then down to $39 million) and threatened with an exchange crises, the GOT signed its first Stand-by Agreement with the IMF ($14 million). The IMF stabilization program called for an immediate devaluation of the dinar by 20%, a 10% increase in taxes in 1965, and ceilings on (1) Central Bank credit to the GOT, (2) Central Bank credit to commercial banks, and (3) net commercial bank lending to the GOT. The dinar was devalued in September 1964, IMF reports at the time of the FY 65 program loan negotiations indicated satisfaction with GOT performance on taxes and credit.

Secondly, the GOT had adopted the U.S. recommendations for preparation of an AEB relating the new multi-year investment plan for 1965-68 to yearly budget estimates. As mentioned earlier, the first AEB was scheduled for release in late 1965 and covered the GOT 1966 fiscal year. Drawing on its previous experience, the U. S. made no commitment to the targets or the financing needs of the Second Tunisian Plan.

Thirdly, the IBRD/Consultative Group was being strengthened in 1965 to provide a multilateral forum for the annual review of performance and requirements.

These three developments were encouraging. The U. S. had been actively promoting GOT relations with the IMF, formulation of an AEB, and revitalization of the CG, and progress on all three fronts promised significant improvements in monetary and fiscal policies and consequent relief to the balance of payments. The austere IMF stabilization plan adopted by the GOT was expected to cut 1965 imports 33% below 1964. Further the GOT had reduced a few of the major social investments which A.I.D. had argued ought to be tailored to budget availabilities. The plan which the GOT had developed in late 1964 for improving the balance of payments was "not fully satisfactory" to the Mission, but the jelling of GOT relations with IMF and the IBRD offered welcome support to the Mission in its efforts to persuade the GOT to more practicable programs.

F. FY 66: $15 million (DL Loan #026)

Although authorization was originally promised for December 1965, following GOT review of the AEB, the FY 66 loan was signed in May 1966 under new ground rules. Six economic conditions were included among the Conditions Precedent. The loan was split into two tranches -- of $8 and $7 million -- and release of the second was made contingent upon those conditions. In addition, the GOT was told that further program lending would depend upon several actions to protect the U. S. balance of payments.

The six economic conditions were all stabilization measures. The GOT was obliged to adhere to the new IMF ceilings on 1966 domestic credit. It was expected to limit gross 1966 investment to available noninflationary finance, to increase the surplus on the current budget in order to help finance those investments, and to indicate the budget and foreign exchange implications of the gross investment package. It was expected to limit the use of short and medium term suppliers credits for financing the payments deficit. (Suppliers credits -- particularly French and Italian -- comprised a disproportionate share of Tunisia's foreign debt and annual debt service.) Finally, the GOT was asked to liberalize the import licensing system for essential goods, thereby stimulating private sector imports.

In side discussions associated with the loan, but not as conditions for disbursements, the Mission further advised the GOT that the U. S. Government expected the latter to take account of the U. S. gold problem, and tailor its foreign economic relations accordingly. In particular, the GOT was asked to (1) survey the U. S. to identify additional U. S. exports suitable to Tunisia's needs, (2) consider holding more of its dollar reserves in New York banks and (3) seek to improve its short-term debt position, especially with France. The origin of these recommendations was the U. S. Treasury, which had advised President Johnson that it was concerned with the indirect leakage of program loan dollars to West Europe and would oppose future program loans unless remedial action was taken. The Treasury's objection, combined with the new procedure of interdepartmental and Presidential approval, actually delayed the authorization by several months.

The Mission justified the original loan on the basis of the three favorable developments mentioned in the last section (referring to the IMF, AEB, and CG), and the obviously painful decisions the GOT had to take in order to conform to the IMF program (for example, taxes were increased by 10% across the board, credit ceilings were strictly observed and capital expenditures had been reduced). Moreover the major macro-economic indicators had performed well during 1965 -- a 5% annual increase in GNP without significant inflation.

In September 1966, four months after the Agreement was signed, the Mission advised AID/W that the second tranche review was completed and that the economic conditions precedent to release of the second tranche, in general, had also been satisfied. This was open to question, since the budget targets were later exceeded and two of the credit ceilings were in jeopardy. But the 1966 harvest was far below expectations and this factor could reasonably be blamed for most of the budget difficulties. Furthermore, the GOT had held supplier credits well within the ceiling. In any case, AID/W concurred with the Missions's judgment and the second tranche was released, on schedule, in early October.

A.I.D.'s long-range strategy had shifted once again. FY 66 documents suggested a swing back toward the older position, which postulated that the entire A.I.D. program was an interim device to tide Tunisia over until a viable relationship with her trading partners could be worked out, and that the program loan in particular had a very short future. Indeed in a May 1966 memo to the A.I.D. Administrator the Bureau of the Budget advised that the President had approved the FY 66 loan only after consideration of the Administrator's assurance that Tunisia's cooperation would be sought in adopting measures favorable to the U. S. balance of payments, that the GOT would be advised the U. S. intended to phase out of program lending by FY 69 or FY 70 and that while the total need for program aid would disappear by 1972, other sources of program loan support ought to be vigorously wooed in the interim. What accounted for this latest turn in A.I.D.'s Tunisia policy is not clear. Pressure from the U. S. Treasury was obviously an important element. In the May 1966 Program Memorandum (FY 68-72), the Mission still referred to the program loan as a major instrument for leverage, and the listing therein of socio-economic objectives and self-help requirements was still dominated by the kinds of overall economic policy prescriptions which presumably the program loan was most effective in delivering.

Two points should be added. First, despite the primary importance of the balance of payments constraint on stability and growth no increase in exports had occurred since the late 1960's and apart from the general encouragement of tourism, no special emphasis was attached to export promotion in the U. S. leverage operation (relative, for example, to the exalted position of this policy in U. S. leverage strategy in Turkey). Second, A.I.D. had began in 1966 to increase pressure on the GOT to improve the climate for private investment and to reform the import regime to accommodate the needs of domestic private investors. This did conform with program loan experience elsewhere.

G. FY 67: $15 million (DL Loan #033)

The FY 67 loan followed the previous year's pattern, stipulating two tranches of $8 and $7 million. The second was conditioned upon a series of explicit conditions -- somewhat longer and more quantitative than in FY 66 -- which were written into the Agreement. The loan was signed in May. The first tranche was released in July and, following USAID's somewhat scanty but favorable review of performance, the second was released in October. Disbursements started in December.

The U. S. conditions were tied closely to the IMF program of December 1966. The Fund had responded to U. S. suggestions that the Stabilization Program cover areas of domestic and foreign economic policy hitherto ignored, and thus, of the eight self-help measures specified in the FY 67 Loan Agreement, six referred to the IMF list. These six covered domestic credit, the investment program, suppliers credits, the ordinary budget, disbursements of counterpart funds and management of state enterprises. The two conditions added by the U. S. dealt with agricultural productivity and the import licensing system (particularly the earmarking of loan funds for essential private sector imports).

Ben Salah fought successfully in early 1967 to eliminate a series of quantitative targets which the Mission attempted to write into each condition to beef up the IMF program. He revealed that the FY 66 Agreement had been approved by the GOT Cabinet only after four days of sharp debate. The Minister objected in principal to using the Agreement for stating U. S.-Tunisian policy agreements, inasmuch as the document was widely distributed in the GOT and could be easily misunderstood or misused. He felt there were more appropriate and discreet instruments for expressing mutually agreed policies. He said the top administration officials were determined to avoid another battle in the cabinet, and were naturally distressed to find that A.I.D. was trying to toughen rather than loosen the explicit conditioning process. Cable traffic between the Mission and AID/W on this issue was heavy during April and May, with AID/W arguing that such conditioning language was common in program loan agreements, that it served a useful purpose, that the GOT had not observed the less formal targets set in 1965 and 1966, and that the IMF was agreed with this strategy. The Mission was more in sympathy with Ben Salah's position. In the end, the U. S. successfully retained a strict 110 million dinar ceiling on investment (which it felt was the heart of the stabilization program and an essential complement to the IMF credit ceilings) but acceded to weaker language for the two new conditions. The signed conditions were on the average far less quantitative than those proposed in the Program Loan Paper.

Performance criteria were (again) only loosely observed in releasing the FY 67 tranches. Two of the three IMF credit ceilings for 1966 had been exceeded in October 1966, though both were soon recovered without penalty from the IMF. Total public investment in 1966 exceeded the implicit level established in the FY 66 Agreement. The current budget surplus had decreased, rather than increased. Major short-term credits had been arranged which, while not defined as suppliers credits, nevertheless had the latter's undesirable features. Net foreign exchange reserves remained at the extraordinarily low level of three weeks import equivalent.

On the positive side one could point to the reestablishment of price stability (following 18 months of moderate inflation consequent to the October 1964 devaluation), a slight decline in government equipment imports, a dramatic rise in private capital imports, improving relations with France (including the prospect of a new start to nonproject aid), increases in export earnings from phosphate, tourism and crude oil, and a functioning consultative mechanism, based on the AEB, involving both the Consultative Group and IMF. One could also argue that the poor fiscal performance in 1966 and 1967 was partly explained by two years of drought, which depressed revenues and increased public relief expenditures. Overall, mid-1967 data supported release of the second tranche. But in any case, negotiations on both the original Agreement and the release of the second tranche do not seem to have been delayed because of performance factors.

A.I.D. was clearly pointed toward phasing out the program loans as soon as possible, probably in FY 69. It reminded the GOT that the latter would soon have to find alternate sources of nonproject support. The hardening U. S. position on this issue reflected the anxiety of other Agencies in Washington over the final destination of U. S. program loan dollars. Some saw the operation as no more than a device for funding Tunisia's short-term debts with France and Italy. Additionality was a hot issue in the spring of 1967, although there were signs that American exporters were beginning to develop a strong position in Tunisia.

H. FY 68: $10 million (DL Loan #038

The world-wide shortage of DL funds in FY 68 forced the U. S. to lower the offer to Tunisia. In fact for several months the figure was set in AID/W at $5 million. It was pushed up to $10 million in April 1968 just before President Bourguiba's second visit to Washington.

Whether the level would have dropped below $15 million in any case, due either to poor performance or to A.I.D.'s stated policy to reduce non-project lending, is hard to say. For one thing performance was again pretty good. The "key" investment ceiling of $110 million dinars had been exceeded, but IMF and USAID agreed with the GOT that some new foreign exchange availabilities justified the increase (the IMF argues that this is an example of how quantitative indicators sometimes fail to do the job.) Most of the other FY 67 conditions were met with room to spare. With respect to A.I.D.'s policy on nonproject lending, the aid level figures projected in the January 1968 Program Loan Paper would suggest that the Mission was assuming nonproject lending would go on at the same rate ($10 million per annum) at least through FY 70. The implication of these two facts is that the cut primarily reflected the funding problem.

The Mission's draft Program Loan Paper recommended a list of conditions, based on the 1968 IMF program, comparable to those of the previous year. AID/W, under pressure from other Agencies in the U. S. Government, was forced to add other ones, including detailed instructions for improving relations with the private sector and a variety of agricultural policy changes. (The Mission strongly objected to these additions.) It seems odd that A.I.D. would attempt to toughen an established conditioning process at precisely the time it was lowering the offer (and even threatening to cut it to zero) and while other donor aid had grown to nearly $100 million per annum. Nevertheless, the longer list was successfully negotiated. The $10 million loan was signed in June 1968. There will be two tranches, the second following a September 1968 review.

The Mission continues to refer to the program loan as an important vehicle for pursuing U. S. interests. The draft Program Loan Paper dated January 1968 made the following appraisal:

> "In summary, program aid, effectively utilized, has rapid economic 'pay off' potential across a broad spectrum of the Tunisian economy with particular emphasis on the key areas of U. S. interest. Through it, development strategy can be influenced, 'growth points' can be supported, production bottlenecks can be eliminated, private sector investor confidence can be maintained, U. S. commercial relationships strengthened, full use of AID dollars in the U.S. can be assured and GOT economic policy and priorities influenced on a continuing day-to-day basis, as required."

AID/W, necessarily more responsive on its promises to the President of the United States and his Cabinet to eliminate program lending to Tunisia as quickly as possible, nevertheless could agree that program loans "provide us with our most effective leverage in negotiating self-help and essential policy changes." In short, both the field and headquarter staff have expressed themselves in writing to be satisfied that the program loan provides a means to exert leverage on Tunisian policy, primarily on the stabilization policies identified in the Loan Agreements but to some degree also on the long list of developmental reforms which (with the exception of agriculture) were excluded from the program loan negotiations but which Mission personnel were continuously discussing with their counterparts.

III. THE PRINCIPAL ISSUES

A. Did A.I.D. try to exert leverage with the program loan?

The answer is that it didn't in 1962, when program lending to Tunisia began, but that it gradually developed a conditioning system which, by now, in form if not in rigor, is much closer to the LA than the NESA model. This development took place within the context of an internal A.I.D. debate over the advisability of doing away with program assistance.

Explicit conditions on economic policy were first imposed in 1962 in conjunction with the $180 million multi-year commitment. They were not directly related to the FY 62 and FY 63 program loans, and performance was not a central issue in decisions on the level of the loans and timing of their release. During the next two years, however, the link was established. In FY 64 A.I.D. insisted that before the agreement was signed the GOT invite IBRD staff to help formulate a balance of payments program that would halt the loss in foreign reserves. It is possible to interpret the reduced level of lending in FY 64 and FY 65 ($10 million in each, compared with $15 millions in FY 63) as a deliberate effort to keep the annual offer low until substantial improvements had been made in the annual planning and budget systems and until the pressure of domestic policy on the balance of payments was relieved.

The LAS report in early 1965 articulated the new thinking on program loan leverage. The program loan was identified as the principal instrument for influencing growth policy. The report was modest in its estimates of the degree of influence the U. S. could expect from an increment equivalent at best to a few percent of the annual import bill. But it obviously thought the cumulative effects of a sustained conditioning process were very promising.

A new conditioning system was installed in the FY 66 Loan Agreement. Six stabilization policy prescriptions were explicitly introduced into the Conditions Precedent, and the loan was divided into two tranches of which the second was not to be released until a joint review of Tunisia's performance established that the conditions had been met. Furthermore, the next year's loan would depend upon continued acceptable performance in these areas and others discussed verbally with the GOT at the time of the negotiations. In 1966 a set of side conditions dealing with additionality were attached informally to the agreement. That procedure was not repeated the next year, but a large group of recommendations dealing with both stabilization and development policy were under continuing discussion throughout this period and by implication were conveyed to the GOT as implicit guides to U.S. largesse.

In FY 67 and FY 68, A.I.D. progressively expanded the system by adding quantitative indicators to conditions that previously omitted them, and by adding conditions dealing with private imports and agricultural policy. The GOT fought this expansion, claiming that it could have political repercussions and was no improvement upon the implicit understanding that already existed. A.I.D. nevertheless was able to strengthen the language in the FY 67 Agreement, and again in the FY 68 Agreement. The fact that A.I.D. made the power play in 1968 despite a reduction in funds -- the Mission was actually an unwilling instrument of conditioning strategy -- suggests that some officials in AID/W were convinced the conditions were paying off (or at least that officials of the U. S. Agencies represented on the Development Loan Committee were so convinced).

An important element of program loan leverage in Tunisia is the collaboration of A.I.D. with IMF and the IBRD, particularly the former. IMF Stand-bys have been agreed annually since October 1964, which means that Tunisia was accustomed to explicit written conditions before A.I.D. introduced them into the agreement in early 1966. It also means that the leverage process was multilateralized. But the Mission has usually led, not lagged, the IMF team: U. S. encouragement of a GOT-IMF relation was important in 1964, and the U. S. steered the IMF toward more frequent use of quantitative measures and a wider range of policy prescriptions. Thus, A.I.D. gained leverage through the GOT-IMF relationship.

Another important element of program loan leverage in Tunisia is the emphasis on the negotiations and the annual reviews that preceded them. The two-tranche system was introduced in FY 66 and in theory the second tranche was related to performance during the immediately preceding period. But the midterm review doesn't seem to have been taken seriously. Moreover the annual loan level itself seems to have been divorced from self-help performance, the $10 to $15 million range was determined on balance of payments criteria. Given that the level and release of program loan funds was in practice not tied to self-help, the explanation for any leverage that we did exert would have to be simply that as the major donor America could insist on reviews and negotiations and influence GOT policy through the continuing dialogue.

B. Did A.I.D. get leverage?

The primary focus of A.I.D.'s conditioning process until recently has been the level of foreign reserves, in particular on tailoring the level of imports to earnings. At least this is the implication of most formal submissions to AID/W. A secondary target has been on encouraging the GOT to seek other donors to take over from A.I.D. the role of lender of last resort. On both counts, Tunisia has done poorly, and if these are the standards of leverage then the answer to the question is no.

There are three reasons why these were unnecessarily harsh standards. In the first place the problems addressed were exceedingly difficult. In the second, the GOT actually tried rather hard to do something about them -- with one (explicable) exception. In the third, the GOT did other things which A.I.D. wanted it to do, though these wants were not all expressed in the program loan negotiations.

First, Tunisia was caught in a cross fire on the current account from which there was no immediate relief. Invisible earnings fell precipitously as the French and Algerians withdrew. Traditional exports were boxed in and vulnerable to forces beyond Tunisia's control (wine and wheat enjoyed French preferential treatment at the pleasure of the French, olive oil faced increasing competition from vegetable oils, phosphates saw no promising market opportunities). A moderate increase in imports was vital to sustain Pres. Bourguiba's popular investment programs and achieve the targeted 6% rate of growth. Since there was a rigid import control system already in effect and not much fat on the list of nonessential imports, and since earnings were falling, balance in the current account in the short run really meant cutting the investment import program. This, in turn, meant sacrificing a successful growth program. It was a lot to ask of the President. With respect to inducing the West Europeans to guarantee the import program, the obvious choice was France. But Franco-Tunisian relations were shaky -- the expropriations in 1964 knocked the French out of an active donor role for two years -- and A.I.D. couldn't press the Tunisians to compromise on such a sensitive issue.

Second, the GOT self-help record on the current and capital accounts was not unimpressive. Import controls were tightened, and cuts were made in projected expenditures for social infrastructure and work relief programs. The GOT devalued the dinar by 20% when the IMF told it to. It kept a remarkable degree of control over wages and prices. It also has stayed under the IMF credit ceilings almost continuously since 1964. In fact it conformed well to the spirit of the A.I.D. conditions, which was to protect the trade balance by avoiding inflationary fiscal and monetary policies. Moreover, it played ball with the IMF and IBRD, set up the Annual Economic Budget, and dramatically increased local revenues. These are the progress indicators that were of primary concern to the reviewing officers in the Mission. Though the announced goal was spelled out in terms of foreign reserves, their working objective was to promote an adequate stabilization constraint on Tunisia's ambitious development program and in this accounting they could take some satisfaction. The GOT failed only to the extent that the total job that had to be done required much more.

Third, the GOT overall self-help record as such -- apart from its impact on the foreign account -- was quite good. Most of the reforms and measures identified in the last paragraph would have been acceptable indicators of performance in their own right. In addition, there has been some progress in such areas as the rationalization of the state enterprises (e.g. railroad rates have increased and the deficit eliminated) and the easing of controls on private sector participation (a development bank was turned over to a private group; 70% of the program loan imports have been directed to the private sector in the last two years; etc.).

Self-help performance doesn't necessarily imply U. S. leverage. The Tunisians may have done these things anyway. It is quite clear, however, that the GOT has shifted substantially since 1961 towards a fiscal position which balances growth against stability, and has paid a price in foregone welfare investments. It also has accommodated itself to the budget review process sponsored by the U. S., IMF and IBRD, and inevitably absorbed the disciplines involved. The dramatic loss in foreign exchange between 1960 and 1964 would have forced Tunisia to take some corrective action. The U. S. presence, particularly directed through the program loan negotiations since early 1964, undoubtedly helped shape the action program.

Parenthetically, one should notice the differences in how A.I.D. handled the Tunisian and Turkish leverage operations. Both countries were characterized by fairly stable prices and a reasonably high rate of growth. Both were threatened by a deterioration of the current balance. In Turkey A.I.D. let IMF handle the stability indicators and put most of its own efforts into export promotion and exchange reform. In Tunisia, A.I.D. teamed up with IMF on the stability indicators, and postponed export promotion and exchange reform. Tunisian exports have done well in the last two years, particularly crude oil, phosphates and tourism. But the Mission couldn't have predicted this five years ago (except tourism), and did little with its program loan to make it come about. The Mission argued, however, that the GOT was doing about all it could for exports.

C. <u>Can the leverage be attributed specifically to the program loan?</u>

Until FY 64 the U. S. made no use of the program loan as an instrument of leverage. In fact it explicitly attributed whatever influence the Mission had to the whole A.I.D. program. But it didn't really try to use the influence to affect particular policies, and, not surprisingly, didn't have much to show.

Starting in FY 64, A.I.D. took a more active position on stabilization policy and began to direct its influence through the program loan. The conditioning system was substantially in place by early 1966. But as noted above, the U. S. insisted throughout the post 1963 period (with the exception of 1965) that the program loan would be dropped soon regardless of performance and rarely manipulated either the loan level or release date to enforce its conditions. In these circumstances, the credibility of the performance-loan relation must have been nonexistent. If the GOT was performing, it wasn't doing so to buy a second tranche release or a new agreement. The instrument of persuasion was apparently not the loan itself, but the opportunity it provided to discuss matters of general economic policy. The Tunisians knew they had no influence on the size of the program aid package -- when the U. S. was ready to cut it out of the program it would be cut, until then it would carry on at the old level. If this interpretation is correct, whatever specific leverage A.I.D. had on any single policy was due to the American presence or the overall A.I.D. program, and only in part on the program loan. The program loan was a fundamental source of leverage, but it was/concealed source and at any one time the GOT probably could not have identified its role.

I have not yet mentioned the PL 480 sale and loan agreements. For the last two years these agreements have set conditions on GOT performance in the area of agricultural policy. These conditions were made explicit in the agreements and set forth in some detail, i.e. establishing a network of marketing cooperatives. One of the reasons the GOT objected to the inclusion of agricultural policy in the FY 67 program loan was that the same points were already covered in the PL 480 documents. Insofar as these conditions were confined to the agricultural sector, there is no confusion of results with the leverage effects of the program loan on stabilization. It is worth noting, however, that there has been little overall increase in agricultural output for years, but structural adjustments promising future increases have been made.

D. Were leverage effects mixed with resource transfer effects?

No, because the resource transfer effect on performance occurs when A.I.D.'s conditions are designed to encourage an increase in imports or a shift in import composition. Most of the A.I.D. conditions since 1964 have tried to discourage imports. There is of course the one exception where, starting in the FY 67 Agreement, A.I.D. argued for a greater private sector role in the economy, and got the GOT to accept a minimum percentage for the share of loan funds which would be allocated for private sector use. The share is now running at 70%, considerably higher than the initial minimum of 20%. These funds were channeled through intermediate credit institutions, and, considering the matching funds offered by local secondary borrowers, resulted in a reallocation of internal investment funds. To the extent the import control system has had to be modified to accommodate the U. S. requirement, one could talk about resource transfer effects. But there has been no serious effort to push the GOT toward liberalization.

IV. DETERMINANTS OF LEVERAGE

A. The Loan

1. Size of loan. There is no evidence of a correlation of size of loan with leverage, and in any case the level has generally been determined by source-procurement factors. The U. S. in FY 68 was able to squeeze more conditions into a smaller loan offer. But it remains to be seen whether it will get any more leverage.

2. Changing aid level. The program loan level is about half that of the annual nonproject grant program which preceded it. But the program loan level has remained between $10 and $15 million since FY 62, and the shifts between those two figures has had no demonstrable effect.

3. Dissipation through time. A.I.D.'s leverage has probably increased since FY 64. But the conditioning system has been toughened. It is impossible to guess what the difference in performance would have been if a tough system had been imposed at the beginning of the period and not changed.

B. The conditioning system

1. Policy area in which exerted. Prices have been very stable in Tunisia. The only inflationary periods followed the 1964 devaluation and the poor harvests in 1960 and 1966. Fiscal policy has been generally successful as well: revenue is way up, current expenditures have increased only gradually, and

the ambitious investment projections of earlier years have been substantially reduced. There was slippage from some of the IMF/AID fiscal indicators in FY 67, but that can be attributed to the poor 1966 harvest. I gether there has been some progress in improving the operations of the state enterprises. Further, the GOT in the last two years has kept well below IMF/AID ceilings on Suppliers Credits. These were the principal policies which were specified in the Loan Agreements. None of them did badly. Some did very well. None of them, however, had the salutary effect on the current account the negotiators had hoped for.

2. Rigor of loan condition enforcement. The conditions were not enforced at all, in the sense that tranches were reduced or delayed pending improved performance. See the discussion in section "III. A." above.

3. Specificity of loan conditions. In FY 66 USAID shifted to a system which included explicit written conditions, some with quantitative indicators, on a variety of stabilization policies. The credit indicators were violated briefly in 1966, but otherwise have been respected. Some of the qualitative stabilization policies were adhered to; some were not. The investment indicator was violated, but was later criticized by IMF and USAID as not having been appropriate ("as things turned out"). There has not been much progress on either of the two development conditions added to the FY 67 Agreement. From this experience it is hard to judge whether quantitative indicators are to be preferred.

The deterioration in the country's monetary and credit accounts led eventually to the IMF loan and the introduction of explicit conditions. History appears to indicate several instances in which the GOT was either unable to stay within the IMF ceilings, or had difficulty in meeting them, but bent over backwards to do so. During the draft AEB exercise of September 1966 the GOT pulled back from investment targets that would have resulted in breeching the IMF ceilings after USAID pointed out the importance of observing the IMF agreement and the close relation of U. S. aid and other aid to that agreement. It is difficult to say whether the inclusion of specific U. S. targets equivalent to those of the IMF actually strengthen the IMF programs, but the GOT did have two "contracts" to worry about and, unlike the IMF, A.I.D. was in residence to guarantee observance of the joint targets. The remarkable success of the Government's monetary and credit policy was obvious before the IMF conditions were first announced in 1964. It isn't possible to say whether the GOT would have got along as well without the IMF ceilings, or whether the IMF programs were improved by the support of specific U. S. targets.

4. Number of loan conditions. There is no information to make a judgment. Two conditions were added in FY 67 to the six included in the trail-blazing FY 66 Agreement. The Mission report "satisfactory" progress on both, but there is reason to dispute that judgment and in any case we have no idea whether their inclusion diluted A.I.D.'s leverage from the other six.

C. Environmental factors

1. National politics. A.I.D. has been dealing with President Bourguiba, the Neo-Destour Party, and a fairly stable political environment since 1957. The Tunisia program loan leverage experience should be as free from domestic political disturbance as any country experience could be.

2. International Politics. The U. S. has a strong interest in preserving friendly relations with President Bourbuiba. His moderating role in the Arab family of nations and the Palestine dispute has fitted well with U. S. foreign policy. Therefore, it is reasonable to suppose that the level of program lending, which the GOT strongly prefers to project lending, has been determined as much by political factors as anything else. This would reduce the credibility of any threat to reduce or delay a loan.

Conceivably the French helped determine the amount of leverage we got. As sometimes advisors and as major trading partners they could have exerted a negative or positive influence on GOT performance with respect to each of the A.I.D. conditions. I have not looked into this.

3. Multilateralism. Without doubt multilateralization of the conditioning process substantially improved its effectiveness. The IBRD/CG was inoperative between 1962 and 1964, but starting in the fall of 1965 took an active role in program review. Since the annual CG sessions preceded the A.I.D. program loan negotiations by several months, they provided a forum for the U. S. to develop other donor support in advance of the negotiations. But they also exerted influence in their own right since the GOT sent top level officials to the meetings and was exposed to the principal concerns of all its donors. The CG would have been more influential had France been a willing member, but Franco-Tunisian relations were strained throughout much of the period.

The IMF input was even more substantial. The Stand-by Agreement provided the vehicle for imposing controls on domestic monetary and credit policy. Later it included fiscal and trade policy as well. Most of the A.I.D. conditions simply referred to the IMF program worked out in November and December of the previous year. It is not clear to what degree the U. S. would or could have taken over these functions if the IMF had absented its position. The annual Stand-bys averaged $10 million since 1964, not much less than the average A.I.D. program loan and presumably of no less appeal to the GOT.

V. CONCLUSIONS

The Tunisian experience with program loans suggests the following conclusions:

A. Through the loan negotiations and accompanying dialogue, A.I.D. secured considerable influence over the shape and direction of GOT policy. Although no progress would have occurred in the absence of program loans, the loan negotiations deserve credit for some of the advance towards stabilization, effective planning, rationalization of agricultural investments, and the tailoring of imports to earnings.

B. The "leverage operation" is something of a misnomer in the Tunisian case. While it is true that the U. S. negotiating teams occasionally acted tough over the inclusion of conditions in loan agreements, most of the U. S. influence was exerted informally and reinforced policy decisions which the GOT was close to taking anyway. The Mission argues that nothing was lost by not taking the GOT to task for occasional infractions of mid-year tests, nor by avoiding any sign of a preparedness to use the instruments of leverage -- the threat to withhold or reduce a loan.

C. Coordination with IMF and IBRD greatly reinforced U. S. influence, taking much of the sting out of bilateral interference.

D. The commendable self-help performance appears to be related to the strength and continuity of President Bourguiba's government.

KOREA

by

Elizabeth Carter

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PROGRAM LOAN STUDY: KOREA

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Program Loan Study: KOREA *

I. INTRODUCTION

Program loans are a relatively recent form of aid to Korea. The first one was signed in FY 1966, after a long period of U.S. assistance. Two more followed, one in FY 1967 and one in FY 1968. A fourth and fifth were planned for FYs 1969 and 1970. Although these loans have been small -- $10 or $15 million out of a total U.S. aid program averaging over $300 million -- they have been an effective and important instrument of leverage. Each loan has contained only two to five quantitative conditions, all related to one policy area -- stabilization. The U.S. has released proportions of the two equal tranches of each loan according to the number of conditions the Koreans met.

Program loans have been used for leverage on Korean stabilization performance along with SA commodity assistance grants. The grants preceded the loans and have been continued simultaneously at higher, though declining, levels. The first program loan, in FY 1966, was for $10 million, while the SA grant was $60 million, and A.I.D.'s total program $144 million. The FY 1967 program loan was for $15 million (later reduced to $12.5 million when part of a tranche was deobligated after the ROKG did not meet a condition), and the SA grant was $45 million in a total A.I.D. package of $113 million. The FY 1968 program loan was $10 million, the SA grant $30 million, and the total A.I.D. package, $75 million. During these three years there were large MAP and PL 480 programs for total assistance programs of $420 million, $335 million and $354 million, respectively. Although total U.S. assistance was used for leverage on Korean stabilization, the program loans and grants were the primary direct instruments.

SA program grants have been designed to help fill a large resource gap, and the local currency proceeds generated by SA-financed imports have been used almost exclusively to support a substantial military budget, important for U.S. security in Northeast Asia, and for Korean participation in Vietnam. Since 1962-63, SA grants have been used to exert considerable leverage on Korean stabilization performance. The U.S. has withheld parts of the grants because of poor Korean performance, or offered an additional amount beyond that announced to induce the Koreans to make certain policy changes.

The program loan was introduced in Korea for a number of reasons. It was part of the general shift in the Korea program from grants to loans and from emphasis on budgetary support to development. Further, with the SA grants being cut back, some thought Korea needed another form of commodity aid. Probably more importantly, many felt A.I.D. had less leverage than desired through the SA grant because of its importance for political support, military budget support, and for covering critical short-term import flows. The program loan was introduced as a carrot, a marginal element of assistance, but one specifically aimed at stimulating better stabilization performance.

* Research completed in November, 1968.

UNCLASSIFIED

Since 1963, the U.S. has applied leverage on Korean stabilization performance by negotiating annual stabilization agreements with the ROKG at the beginning of the calendar year, which is also the Korean fiscal year. The negotiations have involved hard bargaining, and the Koreans have had to accede to tough conditions, both quantitative and qualitative. Quantitative targets have included year-end ceilings on money supply, central and local government budget deficits, and credit volume by sector, as well as floors on revenue and Korean foreign exchange reserves. Negotiation of a stabilization agreement has been followed by joint quarterly reviews of performance, where targets have been set for the following quarter. There have also been constant communications and joint staff work on stabilization policies.

Each year there have also been negotiations on the Korean budgets, culminating in a budgetary agreement between the two governments in late August just prior to the submission of the next year's budget to the National Assembly. Thus two major sets of negotiations -- one focusing on the budget and the other on the total annual stabilization program, permitted mutually reinforcing action at two key policy pressure points and permitted the negotiations to be more detailed than if the whole package had to be negotiated at one time. The discussion of the following year's budget also led to a review of the current year budget and permitted A.I.D. to exert pressure on that budget in the latter part of the year when major decisions were being made. The provisions of the budgetary agreement have been incorporated into the following stabilization agreement. The budget discussions have dealt with a wide range of matters affecting both stabilization and growth, and have included some largely informal U.S. intervention in regard to key budget allocations to support selected policies and projects such as family planning, agricultural pricing and stockpiling, and local currency support for A.I.D. supported projects and programs. We have tried to block ROKG approval of bad investment projects, and get the ROKG to reduce or eliminate undesirable subsidies, and improve tax administration and local government finance. The key concern of the budgetary agreement, however, has been increasing domestic revenue and using the budget properly to produce an optimum effect on stabilization and growth goals.

We have used potential SA grants for leverage on the negotiation of the annual stabilization program in the beginning of the calendar year. We have usually announced the total SA program for the U.S. fiscal year after the conclusion of a satisfactory stabilization agreement,and then released some funds. We have released additional SA funds at intervals during the year, after reviewing performance under the stabilization agreement. (Fund releases have not been closely linked with the negotiation of budgetary agreements.) Program loan agreements have been signed later in the year, incorporating key quantitative targets taken directly from the stabilization agreement or formulated in line with the general policy directives of the agreement. All three loan agreements have included year-end targets so that performance could be covered for the entire Korean fiscal year.

Deobligation or withholding of program loan funds was easier than with the SA grants. The program loans were offered as a bonus, and the conditions were specific enough so that little value judgment was required in deciding on a tranche release. The release of funds was clearly and unambiguously tied to condition fulfillment. At the discretion of the Mission Director, overfulfillment of one condition could compensate for a small shortfall on another, but the ROKG was not aware of this.

The SA grants had other important purposes, and the conditions of the stabilization agreement to which the grants were linked, though comprising more or less one policy area, as opposed to the typical LA program loan, were nevertheless large in number and not always quantitatively defined. Value judgments on performance under some of the conditions were required, and political pressure could be applied more easily to obtain the release of funds.

II. CHRONOLOGICAL ACCOUNT OF KOREAN EXPERIENCE

A. Pre-FY 1966

From 1957 to 1961, the ROKG and USOM signed annual stabilization agreements, with primary emphasis on price stability, achieved by agreement on a money supply ceiling. Within this limit, permissible budget deficit and credit expansion programs were established. The two governments worked closely together on economic policy through a combined economic board. There was a considerable degree of price stability from 1957 to 1960. Our annual SA grants averaged over $200 million during this time.

Economic stability deteriorated between 1961 and 1963, as the military regime which took over the government in May of 1961 tried to accelerate the pace of capital formation and to lessen the country's dependence on foreign aid by means of a very high rate of monetary expansion. After the coup, the U.S. felt that political instability made rigid implementation of the 1961 stabilization agreement undesirable. At the same time the US had made the decision to cease basing the commodity import level (SA grants) on a calculated budget gap and to convert the basis to foreign exchange ne[illegible]. The result was a greatly reduced SA level, from about $176 million in FY 1961 to $93 million in FY 1962; and we began to tell the ROKG to expect further reductions each year. We intended not only to stop the depressing effects on domestic production of easy imports at overvalued exchange rates, but also to put pressure on the ROKG to collect taxes and to earn dollars to pay for its own imports. Korean visible exports were then only $20-35 million, for a country of about 25 million people. Although we continued to offer sound economic advice, the Korean generals (a) did not believe we meant what we said, (b) did not yet understand the troublesome effects of inflation, and (c) enjoyed both a pipeline of earlier aid and relatively high foreign exchange reserves.

Under these circumstances, USOM felt it did not have the immediate leverage to intervene but rather that sound strategy called for a wait until the ROKG had exhausted its immediate dollar resources and thus until it had to seek U.S. funds and listen to our advice if it wanted them. This result was not long in coming, particularly as the Koreans accelerated their problems with ill-conceived actions.

By early 1963, credit expansion, the budget deficit and the balance of payments situation had begun to cause such rampant inflation that the Koreans had to come to USOM on USOM's terms. The Koreans first made a major effort to seek a greatly increased aid level, sending a high-level team to Washington to reverse USOM's position. But the U.S. stood firm, refusing to raise the level planned, to respond to ROKG budget pressures, or to relax pressure for self-help and against unwise Korean action. Moreover, from November 1962 to May 1963, USOM refused to approve any new economic aid, including SA, DL, and PL-480.

Thus, after its firmness had been sorely tested, USOM's strategy had worked. In February, 1963 a joint task force on stabilization was set up. During the Spring there were rigorous negotiations on stabilization targets for the end of 1963. By the end of May, the U.S. and the ROKG negotiated a stabilization agreement with year-end ceilings on the budget deficit, commercial credit expansion, the money supply, and drawdown of Korean foreign exchange reserves. A working group consisting of U.S. and Korean technicians was to review progress toward these and related goals every two weeks until the end of the year. Under the agreement reached in May, the availability of $15 million of FY 1963 SA funds was to be contingent on these targets being met. Adherence to the stabilization targets was a prerequisite also for any further Development Loan approvals during FY 1964. The $15 million out of FY 63 funds was originally planned for release in three $5 million tranches -- in August, October and December, but the total amount was withheld even during the Korean election campaigns in the Fall of 1963. We were trying to pressurize the ROKG into meeting the year-end targets agreed to in May and were particularly worried about the Korean foreign exchange position. We wanted performance, not just promises. The withholding of the $15 million was used as a political football in the election campaigns, and the ROKG tried to cover up the fact that the U.S. was not so far condoning its 1963 stabilization performance.

In November, $10 million of FY 1964 SA funds were released after negotiation of some key elements of the CY 1964 stabilization program. We released another $3 million in December. But it was made clear to the ROKG that the withheld FY 1963 funds would not be released unless CY 1963 performance were satisfactory.

In early 1964, we negotiated the full CY 1964 stabilization agreement with the Koreans, and in March released more FY 1964 funds. The withheld FY 1963 funds were released in March too, but only after we confirmed that CY 1963 targets had been met. The $15 million was thus withheld for a considerable period of time.

In April 1964, SA funds were used for leverage in a different way. We agreed to release an additional $10 million out of deobligated FY 1964 funds, beyond the agreed annual amount of $66.2 million, if the Koreans devalued the won. On May 3, 1964, the Koreans devalued the won, and we granted them the additional $10 million. Within a year, then, SA funds had been withheld to induce performance on the one hand, and on the other, an additional amount was granted as a reward for good performance.

The CY 1964 stabilization agreement was revised in July in light of the devaluation. During the rest of CY 1964, the U.S. used some grant releases for leverage on the Koreans to carry out the revised program successfully. Performance was not entirely satisfactory, and there was some Korean fudging of year end target figures.

In CY 1965, FY 1965 SA releases were conditioned on the negotiation of a satisfactory CY 1965 stabilization agreement, and performance during the first half of the year. All FY 1965 funds planned for the first half of the year were released, although performance was less than satisfactory on all fronts.

In early 1965, we began discussion on the possibility of a program loan, as a bonus for good performance. Negotiations on the program loan were used for leverage on Korean policies. USOM indicated to the Koreans that if May stabilization targets were met, the preparation of a loan application would begin in June. Action was delayed on the application as there was excessive expansion of credit to the fiscal sector* in April, and a deficiency in net foreign reserves at the end of March and April, contravening the provisions of the stabilization agreement.

To sum up the pre-program loan period, beginning in 1962-1963 we linked release of SA funds to negotiation and execution of the stabilization program. Some funds however, were released regardless of performance. Our leverage problems eased after Park's election in the Fall of 1963, as his government initiated an anti-inflationary program and met the CY 1963 year-end targets. Park's anti-inflationary program was carried out on a fairly sustained and comprehensive basis with a growing sophistication in financial techniques, in close working association with USOM.

The use of leverage prior to the program loan period had major tactical problems, deriving first from the fact that the SA was a major political issue with even the press understanding fairly sophisticated distinctions between various levels and fiscal years. The SA level was regarded as the major and easily identified

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* Central and local government plus PL 480 sales deposits.

indicator of U.S. attitudes towards Korea in a period in which the attitudes and actions of the ROKG towards the holding of elections, which the Korean public assumed to be a major U.S. policy objective, varied. Thus, the Korean public was never clear whether our decisions were motivated politically (by a desire for elections) or economically (i.e. by a desire for good stabilization performance). In fact, they were both.

Equally troublesome was the fact that, with Korean foreign exchange earnings still very low, the Korean economy depended on SA imports for much of its essential raw materials. We could not withhold all SA for long without damaging the economy directly and without raising doubts about future U.S. support, a perhaps even more important, if indirect source of potential damage to the economy. SA generated local currency support of the Korean military budget was an equally important factor. The Koreans were also aware of our tactical dilemma. Thus, the withholding of assistance was a game of chicken, a test of wills.

The program loan concept was devised to work for leverage purposes with the SA program. First, it would permit a reward for good performance while the SA program continued to carry primary leverage for the stabilization agreement. For example, the stabilization agreement required a balanced budget, to be enforced by control of SA releases. We recognized, however, that budget balance could be achieved at various levels, higher levels permitting greater funding for development. The program loan therefore provided a bonus for improved revenue collection which would in turn support a higher balance and greater investment. (Though higher revenue targets were included in the stabilization agreement, A.I.D.'s main concern in judging performance under the agreement was a balanced budget) Second we recognized that not all SA could be long withheld, but we expressly stated that program loan funds could be fully cancelled. Thus, the program loan provided a second layer of non-project import financing which had for leverage purposes greater flexibility.

B. <u>FY 1966 - The First Program Loan</u>

Negotiations for the first program loan were resumed in the summer of 1965, as June stabilization performance had improved, and we had negotiated adequate third and fourth quarter stabilization targets. At this time we indicated what the performance targets of the program loan might be. In August we proposed specific targets. They were based on the stabilization agreement, but some of the quantitative targets, such as a private credit ceiling, were referred to only in general terms in the stabilization agreement, and an interest rate reform was referred to obliquely. (However, we had asked for some action by May 1965.)

The program loan was for $10 million. The funds would be released in two equal tranches based on performance in the third and fourth quarters of CY 1965. There were five criteria for each tranche release; performance under each would be the basis for the release or withholding of one-fifth of the tranche. In other words, the meeting of each target was worth $1 million. This was so stated in the loan agreement. The criteria were the following: (1) Government revenue performance would be evaluated in terms of whether 1965 domestic revenues exceeded 45 billion won through the third quarter and 65 billion won through the fourth quarter. (The 1965 budget originally proposed a domestic revenue total of 57 billion won). (2) Private savings (time and savings deposits) performance, as the ROKG was informed in early September, would be evaluated in terms of implementation of a satisfactory interest reform plan in the third quarter. Performance in the fourth quarter would be evaluated according to whether the average end-of-month levels of private savings for October, November, and December, exceeded 20 billion won. (3) Private credit performance would be evaluated in terms of whether average end-of-month net private credit in both the third and fourth quarters stayed below a 40 billion won ceiling. (The ceiling was established in late July.) (4) Government credit performance would be appraised on the basis of whether average end-of-month credit to the fiscal sector remained below 20 billion won in both the third and fourth quarters. (5) Finally, performance in the area of foreign exchange reserves would be evaluated on the basis of whether the ROKG could prevent the drawdown of net foreign exchange assets to a position below the $15 million floor jointly agreed in March as part of the CY stabilization program.

After A.I.D. procedural delays, the loan was authorized and then signed in December. Meanwhile, the Koreans had met the third quarter targets. There are strong indications that the program loan provided the added incentive for the passage of the interest rate reform which had been sought for some time without success. Inclusion of the implementation of interest rate reform as a criterion for performance under the program loan is believed to have been a significant factor in the ROKG's decision to convene the National Assembly in mid-September (despite continuing opposition boycott in connection with ratification of the treaties with Japan) to pass legislation raising interest ceilings and to implement the dramatic reform on September 30, in time to meet the third quarter deadline. The rest of the targets for both the third and the fourth quarters were met, and the two tranches were released. Korean domestic revenue performance was outstanding. The results showed revenues of 67.8 billion won. The Koreans learned what they could do if they tried hard.

At the same time, we continued to use SA releases for leverage on stabilization performance. In November, a $14.6 million SA grant agreement was signed. A condition precedent was assurance of the continuation of satisfactory stabilization performance under the CY 1965 stabilization program. The agreement also asked that the Koreans produce 750,000 MT of lime during CY 1966, to assure the efficient application and utilization of fertilizer included in the SA import program.

Amendments to this grant agreement, which were like new agreements in that they provided different conditions precedent, followed through to February 1967. The first amendment, dated March 30, 1966, was signed after a satisfactory 1966 stabilization agreement had been negotiated. The amendment provided for an additional $24.4 million. $18.4 million would be furnished immediately, and the remaining $6 million would be released after the ROKG had furnished assurance of the initiation and continuation of satisfactory performance through the first quarter of CY 1966 in line with the stabilization agreement.

The whole amount was initially to be based on March 31, 1966 performance, but for the $18.4 million the conditions precedent were waived, as Korea needed timely fertilizer imports for spring application, and there would otherwise be a break in the flow of commodities.

After another exchange of letters on stabilization in April, a second amendment was signed, providing an additional $21 million. Of this amount, $15 million would be released immediately, and the remaining amount after assurance of continuation of satisfactory performance through May 31st. We subsequently said the conditions precedent of both these amendments had been met and released all funds.

C. FY 1967 - The Second Program Loan

The second program loan, for $15 million, was authorized on July 1st, and signed on July 30, 1966. Its two equal tranche releases were to be based on performance through the end of the second and fourth quarters of CY 1966. The loan was conditioned on fewer stabilization performance criteria than the first loan. There were two criteria for release of the first tranche and three for the second. We though further leverage was not required on private savings and foreign exchange reserves at the time, as performance in these areas had been good.

The two criteria by which second quarter performance would be judged were a net domestic credit ceiling of 59 billion won (covering net private sector, fiscal sector and fertilizer sector credit sub-targets as established under the stabilization agreement), and a domestic revenue target (January 1 to June 30) of 45 billion won. The criteria for the fourth quarter were a net domestic credit ceiling of 60 billion won (average end-of-month for October, November, and December), a domestic revenue target of 100 billion won (January 1 - December 30), plus a budgetary payments carryover limit of 3 billion won.

All targets were based on the CY 1966 stabilization agreement. We thought that these three targets would give the most powerful feasible leverage that year over the stabilization program as a whole. They would all be difficult to achieve. Meeting the domestic revenue target would be remarkable, according to USOM, as when it was negotiated (in the January-February stabilization agreement talks) it represented a very large raising of ROKG sights on revenue. The 100 billion won target represented more than a 100% increase over the 49 billion won domestic revenue of 1964, and a 47% increase over the 67.8 billion won revenue of 1965. Pressure exerted through the stabilization negotiations had much to do with further invigoration of revenue raising efforts in the Spring of 1966.

The second program loan agreement did not specify that the meeting of each performance condition would be linked to a proportionate amount of each tranche. We felt that the Koreans resented the "schoolmasterish" approach of a "point system," especially after good CY 1965 performance. However, the "point system" was still applied. It was put in a side letter from the Mission Director to the Deputy Prime Minister. The effect was thus the same. The two criteria for the first tranche release were worth $3.75 million each and the three criteria for the second tranche, $2.5 million each. The funds for whatever criteria for the first tranche were not met could be carried over and added to the second tranche. Funds not eligible for release after the fourth quarter could be held over and released if performance were adequate in the first quarter of CY 1967, but this was not stated in the loan agreement; nor was the fact that the Mission Director could decide whether overfulfillment of one target compensated for a small failure on another, permitting release of the whole tranche.

The two criteria for the first tranche release were met, and the whole tranche was released. The Koreans did not meet one of the three criteria for the second tranche release, the budgetary carryover ceiling for December 30, 1966. The ceiling was 3 billion won, and the actual carryover was 5.2 billion won. The target was thus missed very substantially together with a closely related and very important sub-target of the fiscal sector balance for the year. A number of other provisions of the 1966 stabilization program were not fulfilled. Accordingly, USOM withheld $2.5 million, or one third of the tranche, and it was subsequently deobligated. We held that meeting the other two targets did not compensate for the wide miss of the carryover target. At Korean request the withholding of the $2.5 million was held confidential to avoid the embarrassment of public knowledge.

$20 million of FY 1967 SA funds were planned for release in December 1966. Based on conditions in October-November, we anticipated that a number of year-end targets of the 1966 stabilization agreement would not be met. Therefore, $7.5 million of the $20 million was withheld. It was later to be used for leverage in negotiating the 1967 stabilization agreement since we did not have sufficient fund flexibility to lose the funds entirely. The remaining amount, $12.5 million was released, under amendment #3 (dated December 30th) of the November 1965 SA grant agreement. The only condition precedent in the amendment was that Korea spend $7.5 million of its own foreign exchange on fertilizer and related costs, to equal the amount of the grant allocated for fertilizer. The grant was to have provided $15 million for fertilizer.

In January-February 1967, a CY 1967 stabilization program was negotiated. As in the past, the ROKG agreed to continue to work with USOM to develop quarterly stabilization targets, as well as to review and adjust the program jointly as such needs arose during the course of the year. In April, a new SA grant agreement, for $32.5 million, was signed. It included the $7.5 million withheld in December, 1966. For the first time, an SA grant agreement provided for the release of funds in three tranches, though the effect of earlier agreements was almost the same. The first tranche of $8.5 million was to be made available on evidence that the ROKG and A.I.D. had executed a satisfactory stabilization program agreement to be carried out by the ROKG in CY 1967. Both the second and third tranches, each $12 million, would be made available during the second quarter of CY 1967, subject to satisfactory performance under the stabilization agreement. Satisfactory performance as of March 31, 1967, was to be the basis for release of the second tranche, and there was a provision for carrying over part of the funds to the third tranche if performance were not up to par. Satisfactory performance as of May 31, 1967, was to be the basis for disbursement of the third tranche. The grant could be reduced if performance were inadequate at the time for the last tranche release. An amendment to the grant in May provided for the release of third tranche funds on the basis of May 15 performance, in order to meet A.I.D./W obligation date targets. All funds provided under the FY 1967 agreement were released.

D. FY 1968 - The Third Program Loan

The third program loan for $10 million was not authorized until December 2, 1967, nor signed until February 13, 1968, though release of the first of two equal tranches was to be based on performance as of June 30, 1967. The delay had to do with FAA appropriation problems, and, probably primarily, a lack of priority given to the loan in the White House, not Korean performance. The Koreans were made aware of the targets in April, 1967. Expansionary pressures existed prior to the June 8th Korean elections. The second quarter performance criteria were to strengthen pressure to limit the rise in liquidity during the election period, and to mop up any excess liquidity as soon as possible after the elections. The criteria for June 30, 1967 performance were: (1) As of the end of June, the total money supply could not exceed 78 billion won and fiscal sector credit could not exceed 15.5 billion won. (2) On a second quarter average end-of-month basis, the total money supply could not exceed 78.5 billion won and credit to the fiscal sector could not exceed 17.2 billion won. All the targets were met, and the tranche was released after the loan was signed in early 1968.

The criteria for December 31, 1967, and release of the second tranche, were: (1) On a fourth quarter average end-of-month basis, the total money supply could not exceed 82 billion won, and fiscal sector credit could not exceed 15 billion won. (2) The gross carryover of the central government budget on December 31, 1967, could not exceed 3 billion won. All the targets were based on the 1967 stabilization agreement. USOM/ROKG stabilization agreements always included money supply ceilings, but this was the first time the money supply was specifically included as a program loan criterion.

During the Fall of 1967, the ROKG had strong doubts that it could meet December stabilization targets, including those in the program loan. USOM, to exert maximum pressure for restraint, refused to alter them. It agreed to modify the stabilization agreement only to allow deficit expenditures in the government to the extent that these deficit expenditures constituted direct payments into time and savings deposits, and therefore did not result in any expansion of the money supply during the fourth quarter.

The Koreans met both the fiscal sector and budgetary carryover criteria at the end of CY 1967, but did not meet the year-end money supply ceiling of 82 billion won. The money supply had increased to 89 billion won.

Instead of withholding part of the second tranche, we decided that more leverage could be obtained by amending the loan agreement and basing the second tranche release on the conclusion of a satisfactory CY 1968 stabilization agreement and performance through June 30, 1968. The focus of the criteria for performance by June 30 would be on key problem areas in the stabilization effort and foreign exchange management policies which were primarily responsible for the Korean failure to restrain monetary expansion in 1967 within acceptable limits.

We had planned to release $10 million of FY 1968 SA funds in the fourth quarter of CY 1967. This release was withheld, partly because of less than satisfactory performance, but also so that all of the lower level of SA funds for FY 1968 ($30 million) could be used for leverage in negotiating a satisfactory 1968 stabilization program, along with the $5 million second tranche of the third program loan.

A 1968 stabilization agreement was negotiated in February. It was more comprehensive than past agreements in enumerating objectives, targets, policies and actions to be undertaken in each sector--fiscal (central and local government), foreign and private credit. A 25% total money supply increase was targeted for the year. There would be joint monthly meetings to monitor progress and performance, to agree on specific policy and other measures, and to report monthly to the regular Economic Cooperation Committee which met quarterly. Further, stabilization commitments to be made to the IMF during forthcoming Stand-by negotiations were incorporated in the agreement for the first time.

The Koreans felt they had opened themselves up to far more U.S. influence on concrete stabilization measures than in the past, and resented the fact that the second tranche of the program loan was tied to new specific performance criteria. The ROKG thought that policy directions should be set in the stabilization agreements, and then the ROGK would perform as best it could. It now felt capable of successful self-help on stabilization without specific strings and numerical ceilings applied to tranche releases.

The amended conditions precedent for release of the second tranche of the program loan were: (1) As of June 30, 1968, credit to the fiscal sector would not exceed 15.5 billion won, excluding changes in 1968 due to the operation of the Grain Management Special Account. (2) As of the June 15 to June 30, 1968 reserves period, Bank of Korea general rediscounts for commercial banks, excluding export loans and certain types of commercial bills, would be eliminated. (3) KFX * import approvals to be financed by credit of over 90 days and under 3 years would be limited to 25 percent of total import approvals for the period January through June 1968; and (4) As of June 30, 1968 the ROKG would be adhering to the terms of the IMF Stand-by agreement.

* Korean foreign exchange

To comply with ROKG wishes, a money supply ceiling was not put into the loan amendment. We thought monthly sector reviews plus the conditions in the amendment would provide adequate safequards. Eligibility to draw under the terms of an IMF Stand-by was made a program loan condition for the first time. This was meant to establish a basis for increased relation of U.S. fund releases to performance under IMF Stand-bys as U.S. assistance phased out, and was to help insure adequate performance in the absence of a fixed money supply target in the loan agreement. There were no June 30, 1968 targets in the Stand-by, but the ROKG was committed to remain throughout the Stand-by period (through March 1969) within ceilings limiting total central bank credit to government and limiting expansion of total bank assets, with both ceilings subject to adjustment in the event foreign assets declined below the January level.

The Koreans reported in July that they had met the revised targets for the second tranche release. As of November, there had not yet been a formal U.S. request for release of the funds, but the Koreans probably did meet the revised targets.

E. FY 1969 - The Fourth Program Loan.

A fourth program loan for $10 million was planned along with a smaller SA program grant of $20 million. These two instruments plus PL-480 Title I would be used together for leverage in the negotiation of a new stabilization agreement. After agreement on a satisfactory stabilization program the entire SA grant would be released (as it was in 1968) along with the first tranche of the program loan. The second program loan tranche would be based on satisfactory performance through mid 1969. In view of the comparative smallness of the SA program and of the total won generated by it for military budget support, USOM did not think it practical to release the SA funds in installments. On the other hand, the program loan, which was designed to finance private machinery imports and which was unrelated to military budget support, could be released in tranches as in the past. The approach planned, USOM believed, would help meet ROKG objections to strings attached to aid, as most funds would be released after negotiation of the stabilization agreement. Holding off on the second tranche of the program loan, would help assure USOM that self-help performance commitments would in fact be carried out. Thus, despite Korean progress in controlling inflation, USOM felt it had to continue to link funds at least partially to performance, not just promises.

The 1969 stabilization program was to focus on key economic policies with regard to Korea's monetary system, external trading system, and capital market. For monetary policy, an effort would be made to rely to the maximum extent upon detailed stabilization agreements worked out between the ROKG and the IMF. Timing problems might not make that practicable as IMF negotiations have proceeded on a schedule differing from U.S. requirements. The U.S. would try to work this out in discussions with the IMF.

III. THE PRINCIPAL ISSUES

A. Did A.I.D. Try To Exert Leverage With The Program Loan?

The program loan was introduced in Korea as a marginal incentive element in the aid package. The funds would clearly have to be earned by good performance. Some officials thought that a declining level of program SA plus its importance for the Korean economy made it infeasible to use the sanction of withholding a portion of SA if stabilization targets were not met. Import financing under the program loan, on the other hand, could be flexible. Disbursement was never inevitable, nor did it have to be. And the specific quantitative targets linked to specific amounts of each tranche made the criteria for judging performance and amounts to be released unambiguous. Performance under the whole stabilization agreement, to which SA grant releases were linked, could not be judged as objectively. It was more difficult to decide how much of an SA tranche to release. However, SA funds continued to be released in tranches until the spring of 1968. Besides they were used for leverage on both negotiation and execution of stabilization agreements. The requirement to obligate funds before the end of the fiscal year made it necessary to base release of funds on May performance for the first half of the Korean fiscal year, and to obtain early release of the following U.S. FY SA funds for leverage on the second half of the Korean fiscal year. Program loan agreements, on the other hand, could require performance throughout the Korean fiscal year. The second and third loans were conditioned on mid-and end-year performance.

B. Did Korea Perform?

All targets for both tranches of the three program loans were met except two. There were about 20 targets in all, so that is a record of 90%, ignoring relative importance and possible fudging of figures in some cases. There is every indication that the Koreans tried hard to meet the missed targets too, though other pressures countered these efforts.

Starting in 1963-64, the ROKG became more and more convinced that Korean growth could proceed without inflation, and the ROKG became increasingly committed to stabilization policies. The stabilization program has been fairly successful. The problems of inflation are not solved, but they have certainly lessened measurably compared to the 1961-63 era, particularly considering the phenomenal growth of the economy since then. The money supply grew by 33.1%, 30.1% and 42.5% in 1965, 1966 and 1967 respectively, compared to a rate of 40% between 1961 and 1962 (60% between mid-61 and and September 1962), but the increase in wholesale prices was 9.6%, 8.8% and 6.8% in 1965, 1966, and 1967, compared to 20.4% in 1963, and 35.0% in 1964. The GNP deflator has shown annual price increases of 12.9% and

11.7% in 1966 and 1967 respectively, as opposed to 28.2% and 32.0% in 1963 and 1964.

The performance of the Korean economy, as is well known, has been outstanding in recent years, with remarkable improvements beginning in 1963-64. Between 1963 and 1967, GNP grew by an average annual rate of about 9.3%, and per capita GNP by an average of 7.6%. Exports increased 484% (42% per year) from 1962 to 1967. Industrial production increased by 21% in 1967, typical of recent performance.

Agricultural production rose by about 40% in four years (1962-1966). Production declined in 1967 because of a drought. In the first year after the interest rate reform, time and savings deposits increased by 169%, and in the next two years the annual increase was by 90%. Domestic savings in 1967 represented 10.6% of GNP, compared with 6.9% in 1963. After a 14% annual rate of increase from 1962 to 1964, domestic central government revenues increased 38% in 1965, 68% in 1966, and 43% in 1967. The ratio of domestic revenues to GNP increased from 7.0% in 1964, to 13.[illegible]% in 1967. The central government budget was kept in balance during this period, while the share of the budget supported by U.S. aid declined from 36.7% in 1964 to 16.6% in 1967. Annual foreign exchange earnings more than tripled between 1963 and 1967, and foreign exchange reserves more than doubled.

USOM expected Korea's overall economic performance in 1968 to be the best since the Korean War. GNP was expected to grow by a record 14%, per capita by 11.4%.

C. Did A.I.D. Obtain Leverage?

Each year the prospect of receiving a program loan provided an incentive for the Koreans to reach the targets for the first tranche release before the loan was even signed. Fairly clear evidence of extra effort to meet a criterion was the passage of the interest rate reform, in a special session of the National Assembly, in time to meet the deadline for the first tranche release of the first program loan. The reform was said to be something the U.S. had been pushing for some time without success. Another indication of the leverage of the program loan conditions was the extra effort the ROKG made to increase revenues in the spring of 1966 to meet the loan target for June.

Although the Koreans became more and more committed to stabilization, and to the goals we espoused, the targets which A.I.D. established in the stabilization and program loan negotiations did raise Korean sights considerably, and required the ROKG to push harder than it would have otherwise. Though the amount of the program loan was small, the ROKG wished to avoid the embarassment of withheld or deobligated funds. The U.S. was highly respected by the Korean public, and U.S. disapproval was not taken lightly. Also, knowledge that the U.S. had withheld aid for poor performance might weaken Korea's credit standing and ability to borrow from other lenders. Further, the

Koreans never knew how poor performance in meeting program loan conditions would affect U.S. decisions on other parts of the aid program.

On the other hand, the ROKG economic ministries used the conditions precedent of the program loan to counteract inflationary programs or policies proposed by other ministries. The program loan provided Finance Ministry economists with an excuse for unpopular policies they wanted to carry through anyway.

D. Can A.I.D. Leverage be Attributed Specifically to the Program Loan?

A.I.D. leverage cannot be attributed entirely to the program loan, especi lly since it was such a small percentage of the total assistance program, and of the Korean trade gap. The weight of the total aid program, the respect which the Koreans had for the U.S. in general and for the USOM staff and consultants in particular, plus the close working relationship U.S. personnel had with a competent group of Korean counterparts were important elements in the leverage picture.

Further, specific leverage on stabilization was exerted through the mechanism of spaced SA grant releases along with program loan tranches, and the SA grants were the key elements in the negotiation of the annual stabilization program. Prior to FY 1966, PL-480 and project DL were even used for leverage on stabilization performance, and the conditions precedent for some project loans, such as an increase in electricity rates, have been related to stabilization goals.

When all the foregoing is taken into account, however, the program loan itself was important, despite its small size. The Koreans probably thought they were more certain to receive declining SA program assistance no matter what their performance, whereas they knew the program loan was specifically based on performance. Performance was more easily judged deficient in the program loan system; there were just a few targets, and little opportunity to insert value judgments. The Koreans were pleased to be able to qualify for program loans -- a sign of their progress toward self-support. Further, some of the conditions of the program loan (for instance the revenue targets) pushed the Koreans beyond what they would have been expected to do (balance the budget) to be eligible for an SA tranche.

As already stated, the political repercussions of deobligation for poor performance was something to avoid. The Koreans were embarrassed by the fact that $2.5 million was deobligated in the Spring of 1967. The deobligation was taken to mean a lack of U.S. confidence, and there was fear it might therefor^ reduce the confidence of both the Korean public and other aid donors.

SA funds d g the program loan period were withheld but never deobligated. The use of the withholding threat, coupled with the real delays in releases, proved generally sufficient to establish our credibility and make the ROKG unsure whether we were bluffing. But the withholding was not as obvious, and all funds were eventually granted. This is not to forget the most embarrassing withholding of $15 million in FY 1963 SA during the elections in the Fall of 1963. The Koreans strove very hard to qualify for those funds, and to qualify on time. In retrospect delays in release proved to be effective leverage.

IV. DETERMINANTS OF LEVERAGE

A. The Loan

1. Size of the loan (and SA grants).

The program loan was a small percentage of the A.I.D. program, and the individual tranches were far smaller than the SA tranches. Size seems thus to have had little to do with the amount of leverage of the program loan. The SA grants, though larger, were becoming a decreasing proportion of the aid program every year, as the Koreans well knew and planned for. A complete phase-out of SA was anticipated by both governments for the early seventies. Thus size of the grants too probably had little to do with leverage.

2. Direction of change in size.

We never offered a larger or smaller program loan contingent on past performance. All three loans were planned to be $10 or $15 million, and the Koreans probably knew this. The SA grants were declining annually. Perhaps the ROKG has thought they would decline even faster if performance were poor. This is somewhat doubtful as the ROKG knew of our commitment to Korea. A.I.D. is expecting to have less influence as the SA level, as well as the total A.I.D. program, declines further. This is one reason A.I.D. put fulfillment of IMF standby conditions into the 1968 stabilization agreement and the third program loan. A.I.D. was hoping to have the IMF take on a much larger role in 1969.

One could say that in the past A.I.D. has induced better performance by reducing non-project assistance. For instance, the large drop in commodity assistance between 1962 and 1963, induced the Koreans to go to great lengths to raise their own revenues and increase exports. Performance has continued to improve as assistance declines.

B. The Conditioning System.

1. Specificity of conditions.

Program loan conditions have been quantitative, and A.I.D. could quite clearly ascertain success or failure in meeting them. One condition, the interest rate reform, was generally stated, but the Koreans were well aware of what was required. The SA grant conditions related to execution of the stabilization agreements as a whole. The stabilization agreements contained many specific conditions, and some general ones. Moreover A.I.D. did not emphasize equally all the provisions of the stabilization agreements. Eligibility for SA funds was thus more difficult to ascertain, yet easier than if diverse and unrelated areas, such as secondary education and drawdown of foreign exchange reserves, had been included in the agreements.

2. Number of conditions.

Since there were a small number of conditions in the program loan, the ROKG knew it could not easily slip by with poor performance on any of them. Perhaps the choice of a small number of indicators which are considered key measures of performance, is a good idea, and could be applied in other countries.

3. Policy Area in which exerted.

It is probably significant that the program loan and SA grant conditions related to only one main policy area, stabilization, and one considered to be very important by both the Koreans (over time) and A.I.D. There were no subordinate policy areas for which action was required in the loan agreements. The same thing could have been done with another policy area. Success might have been less, for instance, in agriculture, where there has been less commitment on the part of the ROKG. There is also the question of the control of the Ministry of Finance over other Ministries (e.g., it has more control over macro policies than agriculture), plus the common assertion that stabilization policy is more amendable to quantitative conditioning than other policies.

4. Rigor of condition enforcement.

Specific targets were linked to specific amounts of program loan funds. One third of one tranche was deobligated when the ROKG did not meet one of three conditions precedent. Meeting of the other two targets was not enough to compensate for failure on the one. Another tranche was delayed and new conditions set when the ROKG failed on one of three targets. Enforcement of SA grant conditions was not as rigorous. Although some tranches were delayed, the Koreans eventually received all of the funds planned, and could thus partially call our bluff.

Enforcement of program loan conditions was rigorous, but not rigid. Targets would be changed during the year if warranted by changing circumstances, and the Mission Director did have the discretion to enable a small shortfall on one target to be compensated for by overfulfillment on another. The provisions of the stabilization agreements also were not rigid.

In the Korean setting, some restraints on the use of leverage should be noted. Since Korea was heavily dependent on A.I.D. for foreign exchange, we chose not to withhold for long funds that were urgently needed by the economy. For example, the punishment for breached conditions in 1966 was tempered by the need for fertilizer imports, a need that had a time cycle wholly separate from overall economic performance. Moreover, since our political objectives could not permit real damage to the Korean economy, and since funds were never unlimited, we had to use available funds for dual purposes: to withhold for punishment and then make again available. Although the latter step re-used the same money that had been withheld, new conditions were sought and obtained before it was committed a second time. This fact, plus the timing delays involved, enhanced our credibility and Korean performance without actual loss of funds.

5. Dissipation through time.

A.I.D. leverage is decreasing now as the ROKG feels capable of handling its stabilization policies itself. The ROKG has been arguing strongly recently that the U.S. should negotiate only on overall policies in the beginning of the year, and let the ROKG work out the program without further strings and quantitative targets. Leverage has not so much dissipated over time. The Koreans just feel that they are now experienced enough to work things out for themselves, particularly as we have planned for them to be self-sufficient in the seventies and have been reducing our assistance gradually to this end.

C. Environmental Factors.

1. Multilateralism.

The U.S. has been the primary source of leverage on Korean stabilization. Our leverage has been directly with the ROKG through the negotiation of annual stabilization agreements, joint quarterly reviews of performance, and constant communication and joint working groups.

a. The IMF. A secondary source of leverage on Korean stabilization has been the IMF. IMF leverage has come through the negotiation of annual Stand-by agreements since 1965. There had been four consecutive Stand-by arrangements negotiated through 1968: in 1965 for $9.3 million, 1966, $12 million, 1967, $18 million, and 1968, $25 million. The Koreans had not yet had to draw under the Stand-bys. The IMF has negotiated stabilization conditions for the Stand-bys usually several months after the U.S.-ROKG stabilization agreement has been signed. The conditions have been roughly similar to ours, but not easily comparable, so the IMF would not appear under U.S. control. There have been discussions with the U.S. about the conditions and coordination of policies, however, both in Washington and Seoul.

IMF conditions, with probably some exceptions, have been less rigorous than ours, not initially, but because the IMF has been much more amenable to changing them during the course of a year. Further, since the ROKG did not need to draw under the Stand-bys, the conditions were less meaningful. The ROKG wanted the Stand-by arrangements, however, to enhance its international financial respectability in the eyes of the IBRD and other potential donors; and the ROKG might have to draw in the future.

The U.S. instruments for stabilization leverage (the stabilization agreements, budget agreements, SA grant agreements, and program loan agreements) did not mention adherence to an IMF Stand-by until the Spring of 1968. At that time negotiation of a Stand-by was inserted into the stabilization agreement, and ability to draw under the Stand-by as of June 30, 1968, was made one of four conditions for the second tranche release of the amended program loan. This was done to further emphasize the need for objective criteria related to the program loan release, to strengthen assurance of adequate performance in the absense of a fixed money supply target, and to multilateralize leverage on stabilization as U.S. assistance declines. We are now encouraging the IMF to negotiate tougher and more comprehensive Stand-by arrangements as a partial substitute for U.S. leverage.

b. The Consultative Group. Since December 1966, there has been an IBRD-led Consultative Group for Korea. It met in December 1966, and May 1968. Eleven countries took part in the 1968 meeting, nine in the first. The eleven were: Australia, Belgium, Canada, China, France, Germany, Italy, Japan, the Netherlands, the United Kingdom, and the U.S. Other participants were the IMF, and the UNDP; the ADB and Austria acted as observers. As with most Consultative Groups, pledges were not made at the meetings. Korea's annual Overall Resources Budget was presented, and the IBRD presented reports on the current economic position and prospects of Korea, plus a summary of projects requiring external financial assistance. The Korean economic situation and the Five-Year Plan were discussed, but no attempt was made to exert leverage on Korea. There has reportedly been no real substance or searching questions in the meetings. The IBRD has not been a significant donor in Korea. In the past it wanted to stay out of an area of predominant U.S. influence, and one that was still threatened by financial instability. In 1968 some Bank staff were saying that the Koreans were doing so well they did not need the Bank's assistance. Predictions were, however, that the Bank would move in with a bigger program in the future.

Other donors were not involved in program lending, and much of the assistance has been commercial credits. The second largest donor after the U.S. was Japan. About half of its $68 million assistance commitment in FY 1967 was reparations payments, and thus its leverage was limited. The next largest FY 1967 commitment, $47 million, was that of Italy and was mostly commercial credits. IDA committed $25 million, and Germany $18 million.

2. International politics.

The respect and appreciation which the Koreans have had for the U.S., because of our assistance after World War II, the Korean War, and our substantial assistance program since, has had a lot to do with the success of our overall leverage on stabilization. However, these factors are limited by the depth of our political commitment to Korea, a fact well known to the Koreans. Moreover, since the Koreans now give us assistance in Vietnam, they can be more relaxed about fulfilling stabilization conditions at home.

Fear of U.S. abandonment after reconciliation with Japan made the ROKG more amenable to conditioning.

3. National politics.

From 1963-64 to 1968 there was little or no effective opposition to the Park government, except over the 1965 settlement with Japan. This made it easier for the ROKG to take tough decisions, and carry out tough policies.

D. Other

1. Amount and quality of staff work.

One of the most important factors accounting for the amount of influence the U.S. had on Korean stabilization performance was the quality of the USOM staff economists, plus the consultants working in the ROKG, and the respect their ROKG counterparts had for them. The two groups worked closely and constantly together on the stabilization program.

2. Training.

The Korean counterparts became not only committed to stabilization themselves, but more and more skilled and competent as economists. A substantial technical assistance program in the fifties was important. The program included extensive training of Korean economists.

The stabilization program, with its associated leverage, had an important educational effect on the Koreans over the period between 1963 to 1968. The program worked. And as it did so, what started as a largely U.S. program, accepted by the Koreans as necessary to get the required aid, became a joint program, and now is becoming increasingly a Korean program. If leverage and its use has diminished, the need for it has also decreased.

V. CONCLUSIONS

The program loan has been used very successfully for leverage in Korea. The relationship of the loan to the SA grant, plus the special relationship of the U.S. and Korea, perhaps indicate that the Korean experience is not wholly transferable. Nevertheless, the Korean experience does suggest certain techniques applicable to other countries. For example, the establishment of a small number of key specific conditions for release of program loan funds could be applied elsewhere. A.I.D. could make very clear that meeting all of a small number of conditions was required for release of funds. The recipient would thus know what the real requirements were. When there are many conditions, even within one policy area, there are more trade-offs, and the recipient may not be expected to meet even a majority of the conditions. The recipient may have little idea of what is expected, or suspect (sometimes correctly) that many or most of the conditions are, if not window-dressing, at least only goals toward which to aim.

The specific conditions in Korea were linked to one general policy area -- stabilization. The conditions could be linked to for instance, one sector, or they could apply to diverse areas, provided the conditions were carefully selected, i.e. reasonable, reachable, and relevant. The conditions must have the proper degree of flexibility, according to exogenous factors which could influence the recipient's ability to meet them.

The program loan itself could be a small part of a total assistance package, or a large part. If it were small, it could be linked in an undefined way (as far as the recipient is concerned) to the rest of the program. In other words, the recipient would not be sure how poor fulfillment of a small number of conditions, would affect the rest of the aid program. If the loan were large, the weight of the loan itself would be influential.

In Korea, specific conditions were linked to specific portions of a tranche. This method could probably be applied in other countries. The important point is that release of funds is unambiguously linked to performance, if A.I.D. easgerly desires that performance.