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DISRUPTING ECONOMIC DEVELOPMENT THROUGH LARGE AMOUNTS OF FOREIGN AID

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There has been a consensus in the U.S. for a number of years that rapid economic development in friendly or neutral countries promoted our national security interests. Economic aid has been an important part of this promotion since World War II.[1/] The early successes with the economic assistance provided to war-torn countries under the Marshall Plan launched these efforts on an optimistic note. Initially it was thought that modest amounts of loans, some commodity assistance, encouraging U.S. businesses to invest overseas, trade concessions, and technical assistance could help low income countries improve their lot. Over time the philosophy and mix of these aid activities have changed substantially (Mikesell). Technical assistance, institution building, training, food commodities, and trade concessions played a much larger role in this assistance during the 50s and 60s than they have the past decade. Increasingly, very large capital loans have come to dominate the aid basket.

Various motives have prompted the U.S. to extend well over 100 billion dollars worth of foreign assistance the past four decades. These motives are bounded on the one side by humanitarian motives, and on the other by national self interests. A number of other motives for supporting

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1/ I will not discuss military assistance in this essay.

foreign assistance lie between these: propagating philosophical views on cooperatives, democracy, local participation, and free enterprise, for example. Others look at foreign assistance as a way of increasing world economic and intellectual interdependence and thus lessening the threat of armed conflict. Also, once donor agencies are in operation they take on a life of their own.

These various cross currents of interests in foreign aid obscure the principal purpose that causes giver and receiver to be involved in aid. Namely, that the aid helps to accelerate the rate of economic growth in the receiving country, helps to ease at least some of the poverty there, and also results in less turbulent societies. In the discussion that follows, I will argue that in too many cases large amounts of donor assistance may help to sustain policies that retard growth, further distort income distributions, and also cause more turmoil in these countries.

Aid's Track Record

In an effort as complicated as foreign assistance it is possible to cite horror stories to "prove" that the process does not work (e.g. Paddocks). While there are numerous cases where foreign assistance projects have fallen short of expectations, and some cases where projects flopped, foreign assistance has been associated with, and I stress associated with, a large number of successful cases of economic development. Some of these successes are countrywide, while in other cases success is represented by new facilities like improved roads, education systems, irrigation facilities, drinking water, housing, and agricultural research facilities. The vast increase in the number of trained people because of foreign assistance is also impressive.

One must be careful not to claim too much for foreign aid, nevertheless. In most cases the foreign assistance has been only a small part of the total investments made. Aid can help boost the development process, but it cannot provide the main impetus. Most of the investments must come from local savings, most of the ideas must come from those who live in the country, and most of the work must be done by those who live in the country. Any activities by donor agencies that lessen the willingness of the local people or organizations to exert additional effort is disruptive to development.

Since the early 1970s it has become increasingly difficult to find aid success stories, and too easy to find countries where economic conditions have deteriorated. If economies had nervous breakdowns, most of the following would be on the "shrinks" couch: Bangladesh, Bolivia, Costa Rica, several countries in Eastern Europe, Egypt, El Salvador, Ethiopia, Ghana, Guyana, Haiti, Jamaica, Peru, Somolia, Sudan, Tanzania, Vietnam, Uganda and Zaire.

There are several explanations for the current scarcity of development success stories: recent energy price increases, rapid population growth, declines in the prices of major exports, droughts, and wars. It might also be argued that economic development is subject to diminishing returns; it may have been easy to stimulate growth in nations with productive resources, but be much more difficult to repeat this in countries with poor soils, hostile climates, and largely illiterate populations. (At the same time, critics of development doctors might argue that after more than 30 years of practice, they ought to be able to treat more difficult cases.)

Essentials of Foreign Aid

Foreign assistance comes in four forms. First, a loan or grant from a donor provides additional foreign exchange, and increases a country's ability to import or to repay foreign debts. Tying the loan or grant to the imports of specific goods may limit the ability of a country to free choice in how the additional foreign exchange is used. But, to the extent that the country would have imported some of the tied-goods, even without assistance, government officials can substitute (or funge) donor funds for own funds and use released moneys for any priority purpose.

A second form of donor assistance can be the provision of physical goods instead of foreign exchange. Grain shipments under the U.S. Food for Peace (P.L. 480) program are examples of this (Larson and Vogel). While commodity assistance does not directly provide foreign exchange, it may allow the receiving government to substitute aid for regular commercial purchases. The commodity assistance adds to the total amount of that good available in the country, and may also allow the government to substitute purchases of other imports with the foreign exchange released by the donated commodities.

A third form of foreign aid is education and technological transfers. Donor assistance may allow a low income country access to individuals with scarce skills, and also be very helpful in financing training abroad. In addition, research efforts funded by donor agencies are an important part of building an experience and information base in LICs. Agencies such as FAO, the World Bank, and the Agency for International Development promote flows of information around the world that help low income country (lic) governments make better decisions.

The fourth form of foreign assistance is the least understood. It includes the policy suggestions and creative synergism that results from the mixing of concerned people from local governments and donor agencies. In its most extreme and least typical form, this involves donor leverage (Tendler). That is, the donor may require local governments to change policies as part of the assistance agreement.

Except in very extreme cases, this leverage is seldom a significant part of what I am talking about. In many cases the conditions included in a loan or a grant agreement are already activities that the government wants to undertake.

Most governments are very sensitive about their sovereignty; few will tolerate being nudged very far off the path they desire to follow. Also, where donor agencies have large amounts of funds to move, they are dependent on the willingness of the lics to absorb money. This symbiotic relationship is further complicated by the presence of several donor agencies whose interests may overlap. If one donor agency takes a tough stand on a policy issue it can result in the government going to another donor agency. Donor employees have little incentive to push lics governments around when one gets inside foreign assistance negotiations, despite what some critics of foreign assistance might think (Hayter; Lappe and others).

The kind of influence that is important is more subtle than leverage. It includes the timely idea that a donor employ provides a government technician, and professional reinforcement and encouragement. The fact that money or commodity assistance is standing in the wings opens the doors for donor employees to participate in policy making. In the long run the ideas and policy suggestions that are informally exchanged may be more important than the money or commodity aid.

Criticisms of Foreign Assistance

It is difficult to classify criticism of foreign aid because of the diverse expectations that people have (e.g. Hayter; Schultz, 1981; and Bauer). Because of the multiple objectives and perceptions of results of aid activities, it is difficult for the average citizen to have informed judgement about its merits. For me at least, foreign aid must be continued despite its shortcomings. My concern is with the current mix of activities, and especially with the large amounts of assistance that I feel may be causing some of the current distress experienced in low income countries. The problems with this assistance lie in three related areas. First, the provision of large amounts of food aid allows governments to sustain low food price policies. Second, large amounts of capital assistance, complimented by additional commercial loans, may allow governments to postpone making adjustments in foreign exchange rate policies to the point where major instead of minor adjustments are necessary. Third, much of the aid that goes to countries in financial form moves through local financial markets. This aid may reinforce policies in these markets that cause misallocation of resources, cause further income and asset ownership concentration, and also undermine the vitality of the financial market itself.

In the discussion that follows I present three cases to show how large amounts of foreign aid have been associated with damaging results.

Agricultural Prices

A major anomaly in economic policies is that high income countries often maintain price supports on agricultural products that result in excess production and disposal programs, while many of the low income countries set price ceilings on major agricultural products that discourage production and force the country to import substantial amounts of food (Schultz, 1978). In contrast to high income countries, these price controls are in force where farmers often are in the majority. The stress placed on building infant industries and supporting them with a number of policies including cheap food, buttressed by large amounts of foreign aid have caused many countries to ignore, yet punish their agricultural sectors.

These policies, combined with population increases, have resulted in many low income countries becoming increasingly dependent on high income countries for food. The adverse effects of low producer prices are only partially offset by donor investments in rural areas. For the past couple of decades a number of students of development have been concerned with the impact that large amounts of commodity imports under P.L. 480 programs have had on farmers' prices in aided countries (Schultz, 1960, for example). Despite these criticisms large amounts of food aid continue to make up a significant part of the assistance given to some low income countries.

The volume of food aid largely depends on the surplus pressures in the high income countries. One of the largest recipients of U.S. food aid is Egypt, the cornerstone of U.S. foreign policy in the Middle East. Background on what has happened in Egyptian agriculture over the past couple of decades is helpful in understanding how food imports and food aid affect rural development activities.

For as long as recorded history, Egypt has been an important agricultural country (Richards). Until the past few years its exports of cotton and grain were much larger than the value of agricultural goods that it imported. Joseph, of the Old Testament, if asked to manage Egypt's grain supplies in the 1980's, however, would likely be embarrassed in giving his family Kansas wheat. During the past couple of decades Egypt has increasingly depended on food imports to feed its population. In part, this is due to the rapid increase in population to over 40 million, to rural-to-urban migration, and to limited arable land. The increasing reliance on food imports is also due to faltering growth in yields and switching by farmers from the production of major commodities like cotton and wheat to other enterprises like vegetables, fruits, and livestock. Irrigation, possibilities for double cropping and good managerial skills among farmers make it possible to shift production from one commodity to another easily.

While other countries like Japan, Taiwan and South Korea have been able to stimulate steady increases in agricultural output on limited land resources, Egypt's agricultural growth rates in recent years have lagged behind population growth rates. In recent years, this has forced the country to import 70 percent of all wheat used and to allow food imports to make up more than one-quarter of the value of all imports (Scobie). As can be noted in Table 1, Egypt's cereal imports, most of which are wheat, have roughly quadrupled since the early 1960s. At the same time the volume of cotton exports, a very important source of foreign exchange, was less than half in 1980 of the early 1960s volume. It can also be noted that the ability of Egypt to pay for its food imports through agricultural exports has fallen, especially since 1972. In 1978 the value of agricultural imports, mostly food, was almost three times as large as the total value of agricultural exports. In contrast, the value of agricultural exports in the early 1960s was about double the value of food imports. Increasingly, Egypt is loosing the ability to feed itself, along with many other African countries (World Bank).

For those who understand the important role that prices play in farmers decisions, one does not have to look far to find an explanation for Egypt's food problems. For a number

Table 1. Egypt's Agricultural Imports and Exports, 1960-1980

	Cotton Exports		Cereal Imports[a]		Wheat Imports[b]		Value Ratios of		
	Thousand M.T.	Million $	Million M.T.	Million $	Million M.T.	Million $	Ag. Imports/ Total Imports	Ag. Exports/ Total Exports	Ag. Imports/ Ag. Exports
1960	374	387	1.4	76	1.3	71	.32	.81	.45
1962	225	208	1.8	117	1.6	102	.33	.71	.90
1964	291	268	2.3	171	1.9	143	.33	.73	.81
1966	348	330	2.4	161	2.3	150	.31	.71	.77
1968	269	276	2.4	144	2.3	136	.37	.70	.57
1970	285	340	1.3	70	1.2	66	.27	.67	.41
1972	295	373	1.8	119	1.7	114	.31	.61	.55
1974	232	714	3.0	739	2.6	670	.51	.65	1.22
1976	165	396	3.4	564	2.9	486	.36	.48	1.85
1978	133	336	5.9	804	5.1	706	.29	.38	2.98
1980	148	423	6.0	1,140	5.4	1,035	N/A	N/A	N/A

a/ Mainly wheat and corn.

b/ Includes wheat products in raw wheat equivalents.

Source: Food and Agriculture Organization (FAO), Trade Yearbook, various issues.

of years the governments of Egypt have maintained price controls, imposed forced sales to the government, and enforced overvalued exchange rates that result in average farm gate prices being far below prices that prevail in international markets. In recent years it has been common for the government to subsidize various agricultural inputs like water and fertilizer, and also to sell primary agricultural commodities to consumers at prices that are lower than those paid to farmers. Recently, food subsidies equaled about 20 percent of all government revenues, and the subsidies for wheat and wheat flour alone came to 10 percent of government revenues (Scobie).

As can be noted in Table 2, the price distortions were especially large for cotton and rice with producers receiving less than one-quarter of the international price, using market rates of exchange for the Egyptian pound. Producers of other major agricultural products, including wheat, received only from 40 to 66 percent of the world market price. At the same time, consumers paid only 16 percent of the world market price for their rice and less than one-third of import price for their wheat. Recently, a 2.2 pound loaf of bread in Egypt only cost consumers about the equivalent of eight cents U.S. It should not be surprising that farmers have shifted out of the production of goods with price controls to livestock, fruits, and vegetables that do not carry these price disincentives.

Table 2. External and Internal Prices for Major Agricultural Products in Egypt, 1980

Product	International Prices Using Exchange Rate*		Internal Prices		Ratios			
	Market	Official	Paid to Farmers	Paid by Consumers	3/1	3/2	4/1	4/2
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	-In Egyptian Pounds Per Metric Ton-				-Ratios-			
Rice	320	269	75	50	.23	.28	.16	.19
Wheat	133	112	77	41	.58	.69	.31	.37
Sugar	436	366	177	100	.41	.48	.23	.27
Beans	243	204	161	100	.66	.79	.41	.49
Lentils	441	370	250	110	.57	.68	.25	.30
Cotton	959	806	230	333	.24	.29	.35	.41

* In 1980 the market exchange rate of one U.S. dollar was .84 Egyptian pounds, while the official exchange rate was .70.

Source: Adapted from Strategy for Accelerated Agricultural Development Team, "Egyptian Agricultural Policy: Diagnosis and An Adjustment Agenda". An unpublished report prepared for the Agency for International Development in Egypt, Cairo, Egypt, April 15, 1982.

As can be seen in Table 3 the terms-of-trade for wheat and corn have been more seriously affected by pricing policy than is true of rice or cotton. This is no accident. Major imports of both wheat and corn, partly funded by P.L. 480 and partly by foreign assistance, began in 1973-74. One can note the decline in the terms-of-trade for these two commodities with the increase in the imports of these two goods. It is highly unlikely that Egypt would have been able to maintain these low food prices and turn the terms-of-trade against wheat and corn producers without the availability of foreign assistance.

The first and most serious effect of these substantial price distortions is on the producers of the commodities whose prices are kept low (Tolley and others). This causes them to shift, where possible, their resources to other more profitable activities. This also results in farmers receiving lower incomes, having less incentive to form capital, and finding it more difficult to repay loans. Overall, low product price force producers to engage their resources in less productive activities, and thus result in less overall product (Krause).

The subsidies that producers receive through cheap credit, free irrigation water, and subsidized inputs only partially offset the inefficiencies caused by these price distortions. While all producers who sell the good with the low price are "taxed" by the price distortion, only those

Table 3. Farm Level Terms-of-Trade for Wheat, Rice, Corn and Cotton in Egypt, 1970-1979[a]

Year	Commodity			
	Wheat	Rice	Corn	Cotton
1970	1.82	1.77	1.99	1.93
1971	1.69	1.69	1.94	1.94
1972	1.80	1.61	2.01	2.44
1973	2.10	1.65	2.29	2.07
1974	2.08	1.70	2.15	2.04
1975	1.77	1.68	1.85	1.69
1976	1.41	1.57	1.66	1.95
1977	1.40	1.67	1.93	1.66
1978	1.31	1.84	1.57	1.89
1979	1.15	N/A	1.42	1.97

a/ The terms-of-trade is calculated by dividing the farm price of the commodity by the estimated average total cost of producing a unit of the good.

Source: M. Ragaa El-Amir and others, "Determinants of Agricultural Price Policy in Egypt," Economics Working Paper Series No. 50, Agricultural Development Systems, Egypt Project, University of California at Davis, November 1981.

who receive the cheap input get the subsidy. If only 15-20 percent of the farmers, for example, get cheap formal loans, only that proportion receives a subsidy through the loan vehicle. Subsidies on input prices only help to overcome part of the resource allocation problem, and make income distribution problems worse. This is especially true with cheap credit (Gonzalez-Vega).

Also, low prices on consumer goods encourage individuals to consume more of the good and to be wasteful in its use. In addition, any program that attempts to administer prices, amounts sold, and imports requires a large number of administrators who do not work for free. These are additional costs that Egypt is paying for importing large amounts of food, above and beyond losing the ability to feed itself.

Foreign Exchange Rates

Recently, a number of low income countries have undergone economic stress due to increases in the costs of energy imports, worldwide and internal inflation, and declining prices for principal exports. Responding to this stress, some countries have chosen to let exchange rates float, others have tried to keep the official exchange rate close to market rates through mini-devaluations, other countries have partially devalued by allowing curb markets in foreign exchange to operate, and still others have maintained fixed rates until they ran out of foreign exchange and were forced to make very large exchange rate adjustments.

Costa Rica is an example of this latter strategy, and is a particularly interesting case to study because it has been, until recently, an island of stability and democracy in a Central American sea of turmoil.2/ Without economic and political stability in Costa Rica it will be very difficult for the U.S. to construct a coherent Central American policy. It is, thus, important for the U.S. to have a clear understanding of what recently went wrong in this small--only 2.2 million population--but important country.

In late 1981 Costa Rica was forced to announce a moratorium on payment of foreign debt. Soon its exchange rate for dollars shot up from less than 9 colones per dollar to over 50; it experienced substantial foreign capital flight; it incurred triple digit inflation; it had negative rates of economic growth; and it was forced into the clutches of the International Monetary Fund. This was quite a change for a country that had had economic growth rates of around 6 percent per year since the early 1960s and had been classified as an excellent credit risk by commercial banks and aid donors (Cespedes and Gonzalez-Vega).

It is surprising that Costa Rica ran into such serious economic difficulties, because its economy has been well

2/ I am indebted to Claudio Gonzalez-Vega for background material, insights and interpretations of what went on in Costa Rica over the past few years.

managed in the past. Also, the country has had ample access to both donor assistance and to large amounts of loans through commercial banks. Without looking at what has in fact happened in the country, one would have expected that Costa Rica could have weathered the recent worldwide economic downturn with only moderate difficulties.

While there are a number of factors that led to Costa Rica's recent economic problems, the roots of these problems can be traced to events in the mid-to-late 1970s. In 1976-79 the price of coffee, a major export of Costa Rica, was relatively high. This was also true of prices on other principal exports. As can be noted in Table 4 the value of Costa Rica's exports increased about 60 percent in 1977 over 1975. At the same time, the international banking system had large amounts of deposits from petroleum producing countries that they were recycling back into non-oil producing countries like Costa Rica. From 1973 to 1979 Costa Rica increased its public sector foreign debt by about a half billion dollars through these commercial sources (Table 4). Along with this, the World Bank, the Inter-American Development Bank and other donor agencies, between 1975 and 1980, added about 700 million dollars to Costa Rica's public sector external debt. Private external debt also increased rapidly during this period and amounted to about one billion U.S. in 1982.

Table 4. Economic Performance Indicators for Costa Rica, 1960-1981

Year	Exchange Rate	Inflation Rate	Value of		Change in	External Debt[b]	
			Imports	Exports	For Ex. Res.	External Donors[c]	Commercial Banks[d]
	Colones per $1 U.S.[a]	Wholesale Price Index	--In Millions of Dollars--				
1960	5.64	6	110	84	- 3	24	4
1961	6.64	- 1	107	84	- 5	24	4
1962	6.64	2	113	93	5	45	16
1963	6.64	1	124	95	5	73	17
1964	6.64	2	139	114	2	81	23
1965	6.64	- 2	178	112	2	113	35
1966	6.64	2	179	136	- 2	124	37
1967	6.64	5	191	144	2	127	26
1968	6.64	4	214	171	10	148	17
1969	6.64	6	245	180	18	137	20
1970	6.64	8	317	231	- 16	131	33
1971	6.64	4	350	225	8	153	46
1972	6.64	8	373	281	2	178	59
1973	6.65	26	455	345	18	203	93
1974	8.57	38	720	440	- 23	251	128
1975	8.57	14	694	493	21	343	168
1976	8.57	7	770	593	65	430	216
1977	8.57	7	1,021	828	109	520	314
1978	8.57	9	1,166	865	- 41	632	412
1979	8.57	24	1,397	934	-106	759	639
1980	14.25	22	1,540	1,002	-204	1,087	648
1981	35.80	82	1,211	1,031	- 52	1,700	1,000[e]

a/ End of year official selling exchange rates.
b/ Year end outstanding balances.
c/ Includes multilateral as well as bilateral assistance.
d/ Includes suppliers credits.
e/ Preliminary figures as of October 1, 1981.

Sources: Victor Hugo Cespedes and Claudio Gonzalez-Vega, "Growth and Equity: Income Distribution in Costa Rica," manuscript in process, September 1982; Victor Hugo Cespedes S. and others, Costa Rica: Una Economia en Crisis. San Jose, Costa Rica: Academia de Centroamerica, Dec. 1981; and Oficina de Planificacion Nacional y Politica Economia, Evolucion Socio Economica de Costa Rica, 1950-1980, San Jose, Costa Rica: Editorial Universidad Estatal A Distancia, 1982.

While this was going on, the Costa Rican government continued to expand employment and expenditures through public and semi-public agencies. The rapid expansion in the public sector was largely financed by donor and commercial bank loans. The savings performance of the Costa Rican economy was poor during this boom period; in large part the savings of people outside Costa Rica were used to finance the internal expansion in the public sector.

Instead of cutting back on public expenditures when export earnings leveled off after the boom in the late 1970s, the Costa Rican government continued to borrow large amounts in external markets, as well as within the country through the nationalized banking system. These loans were used to cover growing internal budget deficits. Massive government borrowing increasingly crowded out private enterprises from both external and internal credit markets. This combined with other factors caused the economic downturn in the economy. Concurrently, the deficits, government borrowings, and rapid increases in the money supply caused a sharp increase in the rate of inflation and capital flight from the country.

Why did the government choose to maintain very overvalued exchange rates until the country was bankrupt? In part the answer lies in the composition of imports that were effectively subsidized by the overvalued exchange rate. A significant part of these imports were raw materials needed to sustain manufacturing in small industries that were set up over the past couple of decades to serve the Central American common market. Relatively cheap imports were an important factor in keeping these plants operating and providing employment for the politically important middle class. Because many of these industries were relatively inefficient, they could not withstand increases in the costs of imported raw materials.

Another important factor that caused the government to resist adjusting exchange rates was a very large foreign debt obligation, one of the highest per capita in the world. Most of this debt was denominated in dollars or other foreign currency. A devaluation of say 100 percent would have doubled the debt obligation in terms of colones. No government, especially one as heavily indebted as Costa Rica's, wants to face the very tough short run adjustments in government budgets required by massive increases in the debt service obligation.

What role did foreign assistance and lending by the international commercial banks play in Costa Rica's current plight? Using 20/20 hindsight, it is clear that international lenders loved Costa Rica nigh onto death. During the late 1970s Costa Rica should have increased its domestic savings. It should have also followed trade policies aimed at encouraging a few efficient industries to emerge that could have been competitive in international markets. With a smaller overhang of foreign debt, and more efficient industries, it would have been easier for the government to make modest adjustments in the exchange rate to help manage some of the unanticipated shocks that occur to any small, relatively open economy. The large amounts of foreign assistance and commercial loans allowed the government to sustain spending patterns, interest rate policies, and foreign exchange rate policies that in the long run have brought Costa Rica to its knees.

Financial Markets and Donor Assistance

A large part of donor assistance moves through local financial markets. This may include direct loans or counterpart funds to expand the amount of credit for housing or for agricultural purposes. In addition, it has been common for donors to help create rediscount windows in central banks in order to pass donor funds to other local financial intermediaries. Where these donor activities bulk large in financial markets they may have a profound effect on what these markets do and how they support the development process. Because of the fungibility of financial instruments these effects are not, as is generally assumed, primarily on the flows of loans to priority sectors or groups within the economy. Rather, <u>the impact is largely on the policies that influence the performance of the financial market</u>. These impacts can be grouped into four categories: (1) interest rate policies, (2) sources of funds used by the financial markets, (3) information flows within these markets, and (4) political intrusions into these markets.

Until recently, a substantial part of the loans and grants from donors aimed at expanding the amount of agricultural credit carried the requirement that concessionary interest rates be charged on farm loans. These requirements reinforced the pervasive attitude that low interest rates were an effective way of stimulating agricultural production and helping the rural poor. Recent research has shown that these low interest rates have not had the desired effects. As Gonzalez-Vega and others have pointed out, these low interest rates cause lenders to ration loans most severely to exactly those groups who are the intended beneficiaries of cheap credit. This results in most loans going to relatively few borrowers who are typically well-off. Research has also shown that low interest rates have a weak effect on agricultural production, a powerful impact on the willingness of people to hold financial deposits, and help to undermine the financial vitality of lenders.

Large amounts of foreign assistance for agricultural credit also adhere rural financial markets to goverment or external sources for loanable funds. Concessionary rediscount facilities through central banks are an important part of the dependency that foreign aid helps to reinforce. One cannot blame a manager of an agricultural bank, for example, for not wanting to offer savings deposit services if he has ready access to large amounts of money through concessionary rediscount windows in the central bank. Foreign donors must bear major blame for the orientation of agricultural lenders toward central banks for their loanable funds and away from clients' deposits.

The large number of government and donor credit projects in rural financial agencies also warps the information collected and analyzed by these agencies. It is not uncommon for an agricultural bank, for example, to have "projectites" because of several dozen credit projects that have been funded by donors or the government. Each of the projects has its own objectives, procedures, and reporting requirements. The lending agency may file monthly or quarterly reports on what is done with the funds in each of the projects. This projectitis may result in large amounts of staff and management time being spent on reports for donors and governments that provide little or no useful information to bank managers.

The fact that donor assistance seduces intermediaries into becoming heavily dependent on central funding makes these lending agencies vulnerable to political intrusions (Olsen). In countries like Bolivia where there are frequent changes in government, this dependency means that the agricultural lenders can be jerked around a good deal because of rapid changes in political forces. Agricultural banks find it impossible not to make a number of loans that are part of the political patronage system, rather than being based on the creditworthiness of borrowers (Ladman and Tinnermeier). Under these conditions it should not be surprising that loan recovery problems occur.

It is difficult through a single case to show the subtleties of how substantial donor intrusions affect financial intermediation. In some of the worst cases, economic turmoil masks the effect foreign assistance has on these markets. In other cases, there is too little information available to draw a clear picture of what has happened in financial markets because of foreign assistance. While far from being one of the worst cases, the Dominican Republic does illustrate some of the problems associated with donor intrusions into rural financial markets.

As can be noted in Table 5, since 1960 the funds handled by formal rural financial markets in the Dominican Republic have expanded rapidly, from 15 to over 240 million pesos. The growth in the volume of agricultural loans made by the Agricultural Bank has been especially impressive. Over the past two decades donor agencies have played a large role in this expansion. Through 1982 donor agencies have granted or lent for agricultural credit purposes in the Dominican Republic about 150 million dollars U.S. In addition to providing large amounts of funds for agricultural credit, donor agencies have been very important forces in

Table 4. Volume of Formal Agricultural Loans Made in The Dominican Republic, 1960-1981a/

Year	Total a/	Agricultural Bank	Commercial Banks b/	Other Lenders c/	Ratios of Credit-to Output e/	Ratios of Ag. Credit-to Total Credit
	--Millions of Pesos d/--					
1960	15.3	12	3.3	--	0.06	
1962	14.1	11	3.1	--	0.05	
1964	29.0	24	5.0	--	0.11	
1966	33.5	21	12.2	0.3	0.13	
1968	42.5	25	15.2	2.3	0.16	
1970	45.4	29	15.5	0.9	0.13	
1972	54.7	31	21.1	2.6	0.13	0.20
1974	119.4	68	46.9	4.5	0.18	0.21
1976	151.9	81	61.9	9.0	0.19	0.20
1978	192.9	112	67.4	13.6	0.21	0.23
1980	278.0	189	89.0	N/A	0.29 f/	0.25 f/
1981	240.3	149	91.3	N/A	N/A	N/A

a/ Does not include loans large firms may obtain outside the country (i.e. sugar industry).
b/ Excludes loans to the sugar industry.
c/ Includes loans made by the Dominican Development Foundation, IDECOOP, various financieras, ODC, and CARITAS.
d/ The official exchange rate is one peso for one U.S. dollar. The curb exchange rate has ranged between the official rate and 1.50 in recent years.
e/ Output is value of total internal gross product from the agricultural sector.
f/ Excludes financieras, ODC, CARITAS, DDF, IDECOOP.

Sources: Banco Agricola de La Republica Dominicana, Boletin Estadistico, 1981; Banco Central de La Republica Dominicana, Boletin Mensual various issues, and various unpublished reports by agencies making agricultural loans in the Dominican Republic. Also, USAID/DR, Agricultural Sector Strategy--Dominican Republic, 1980; and SEA, Plan de Desarrollo Agropecuario 1980-82, 1979.

the formation of several major segments of the agricultural credit system.

Aside from provision of funds and the new institutions, donor activities have had other very important impacts on the operations of RFMs. Most importantly, these large infusions of funds have allowed the government to sustain relatively low interest rates on both rural loans and savings. In recent years these rates have been well below the rates of inflation. The rediscount facilities and the large amounts of external funds for credit also encourage financial intermediaries to become heavily dependent on outside funds. Aside from a few branches of commercial banks, there are very few opportunities for rural residents in the Dominican Republic to place their savings in financial institutions. While authorized to do so, the Agricultural Bank accepts virtually no deposits in any of its more than 30 branches. The formal rural financial market in the country could be construed as a patronal system. Donors pour money into the Central Bank or other major lenders, who in turn pass these favors on to other financial intermediaries, who in turn favor a few farmers with cheap loans.

Low interest rates make it very difficult for the financial system, even if it chooses to do so, to mobilize voluntary financial savings in rural areas. The low interest rates also make it impossible for a lending agency to cover its costs of lending, especially if it makes a large number of small loans to the rural poor. No lender, even if owned by the government, can expect to subsist indefinitely on a diet of subsidies to cover operating deficits. The political will to sustain these subsidies is transitory. To survive, the lender must either consume part of its loanable funds to cover operating expenses, or ration its loans in a way that reduces lending costs. This rationing process results in the large and experienced borrower receiving more of the loanable funds at the expense of small and new borrowers. The net result is that benefits of borrowing are concentrated in the hands of relatively few people and financial markets do a poor job of helping to allocate resources efficiently. This rationing process helps to explain why only 15-20 percent of the farmers in the Dominican Republic have access to formal loans.

Conclusions

Because of fungibility, it is very difficult to sort shadow from reality in foreign aid. It is easy to gloss over major problems and argue for more foreign assistance, or to cite a few horror stories to condemn these activities. While I feel that foreign assistance should be continued, I am very concerned about how large amounts of capital or commodity assistance affect these very important sets of prices: agricultural prices, exchange rates, and interest rates. Imports of large amounts of food allow countries to follow the easy but very debilitating path of keeping food prices low. More forceful central planning and control cannot overcome the millions of decisions made by farmers to produce less because of these low prices. Sustaining a depression in rural areas through low food prices also limits the rural demand for manufactured goods. Under these conditions, infant industries never grow up. More enlightened food price policies are a key ingredient in rural development as well as for overall development in most low income countries. In too many cases, massive foreign aid allows countries to ignore or postpone adding this ingredient.

Large amounts of capital assistance have similar adverse effects on the will of the country to save, to limit the expansion of its public sector, and to make adjustments in exchange rate policies. More countries will be forced to make timely, small adjustments in their foreign exchange rates if they know that foreign aid will not bail them out. Spending more time on helping countries think through their economic problems and less time on moving large amounts of money is a better use of donor employers' staff time.

The damage done by large amounts of foreign aid is particularly serious in financial markets. Large doses of aid encourage financial intermediaries to spend most of their time looking for some place further up the financial system to obtain more cheap money, instead of mobilizing savings.

This aid allows policy makers to ignore the fact that convenient and high return savings deposit facilities are a substantial benefit to those who currently do not have access to these services. Large amounts of aid sustain low interest rates, discourage mobilization of voluntary financial savings, cause lenders to concentrate cheap loans in the hands of a few people, undermine the vitality of the financial intermediary, and make the financial system vulnerable to political intrigue. Further centralization of economic and political power also results from donor intrusions into financial markets.

It is becoming increasingly clear that faulty internal price policies, not the lack of foreign assistance, is the major factor that is causing many low income countries to falter. To the extent that foreign aid helps reinforce these damaging policies, more donor assistance will be part of the problem not part of the solution. A major challenge facing the foreign aid enterprise is to reposition aid activities so they encourage appropriate changes in these misguided policies.

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