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Policy-Based Assistance: A Historical Perspective

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Executive Summary

There is a division of labor among economic aid donors. The international financial institutions, particularly the World Bank and the International Monetary Fund, have primary responsibility for providing assistance conditioned on macroeconomic variables. They have the resources to play this role; and in addition, the IMF seal of approval of a country's stabilization-adjustment program has the potential to call forth additional private resource flows. Both institutions operate in countries in which the United States has major political and economic interests but no full-fledged program of economic assistance.

Both institutions are seeking to play this role, especially since 1980, when it became evident that the financial situation of developing countries had weakened substantially. The major instruments used by the World Bank are the structural adjustment loan (SAL) and the sectoral adjustment loan (SECAL), both of which involve quick-disbursing funds conditioned on macroeconomic targets, such as a country's fiscal, monetary, and exchange-rate policies. All IMF programs are designed to restore balance in external accounts, but special facilities have been established to meet current conditions. These are the structural adjustment facility (SAF) and the enhanced structural adjustment facility (ESAF). Coordination between the Bank and the Fund has been improved in recent years in the use of these of the facilities and programs mentioned.

AID lacks the resources to be a major player in this adjustment process. The AID

facility which theoretically provides the necessary flexibility for setting macroeconomic policy targets is the economic support fund. However, the use of ESF resources for this purpose is constrained by earmarking by the Congress and the concentration of these funds in countries in which the United States has other interests, geopolitical and to retain military bases. Under these circumstances, there would be no credibility if AID were to seek bilaterally to establish macroeconomic policy conditions. The country would know that if push came to shove, AID would have to back down.

AID itself has defined its role as helping to meet vital political, economic, and humanitarian interests in developing countries. The recent report of the task force on foreign assistance of the House Foreign Affairs Committee (the Hamilton-Gilman report) gives the objective of foreign aid as promoting the political and economic stability of nations important to the United States by stimulating economic reform and growth and by responding to humanitarian concerns. This report recommends that AID concentrate in its programs in four general areas: to support broad-based economic growth; protect the environment; alleviate poverty; and promote pluralism.

These overall objectives are best defined in specific programs. Since AID lacks the resources and flexibility to credibly condition its programs on recipient countries meeting macroeconomic targets - even if its wished to do so - its programs and policy conditions are best set more precisely. They should be based on general U.S. interests, such as promoting pluralism and encouraging open economies They should be built on AID's own areas of expertise - its presence in the field, knowledge of the social milieu in which it operates, sectoral skills, and greater ability than the World Bank or the IMF to carry out a continual dialogue with national authorities. It would be unwise for AID to be seen as an echo of the international financial institutions in setting macroeconomic conditions for lending, but neither can AID ignore the existence of these programs. AID can complement these programs by reducing the adverse

impact of on the poor of stabilization-adjustment programs, and by focusing in important areas, such as the environment, health, and education, with which the United States wishes to be identified.

The overall conclusion of this paper is that AID's policy-based lending is best focused in sectors and programs that build on the resources available to it, both financial and human, and not seek to replicate what the international financial institutions are doing in their stabilization-adjustment programs.

I. Introduction

The techniques for foreign assistance favored by the United States have changed over time as the context has altered. "Context" encompasses the U.S. budgetary situation, the development problems being addressed, the other actors involved, the political benefit sought, and perceptions of what has seemed to work and what has apparently failed. However, even as one primary focus has given way to another, a residue remains; approaches are not discarded completely, but are subordinated, perhaps to emerge again when the context changes.

Particular approaches dominate for about five years, give or take a few years, by which time it is clear that this technique cannot solve problems of development; it then falls victim to its critics who advocate a new approach. Point Four and related programs - predicated on official technical assistance and private capital flows to induce development - endured from roughly 1949-1953. This gave way to dominance in U.S. thinking of soft lending (*official* lending since it was concessional), epitomized by the Development Loan Fund established in 1957 (Baldwin, pp. 132-133). This approach, that of modest official funding for specific projects, was supplanted in the early 1960s by the Alliance for Progress and similar programs in Asia based on substantial funding and national planning (Scheman). The Alliance was not the first example of U.S. bilateral policy-based lending - the Marshall Plan was policy based - but it and comparable programs in Asia brought this technique to U.S. aid relations with developing countries. The heyday of the Alliance was roughly 1962-1967, and it expired slowly after that with a prolonged whimper rather than an immediate new direction.

The New Directions, so-labeled, a focus on meeting basic human needs (a rejection of "trickle-down" development), dominated U.S. aid thinking for about five years after

1973. John Lewis attributes the decline in the emphasis on poverty issues to the second oil shock (1979) and subsequent U.S. and international proccupation with financial and structural issues in developing countries (p. 3). These concerns have endured to this day.

None of the emphases of the past 30 years of U.S. foreign aid practice has been discarded completely. Aid for specific projects continues alongside the emphasis on macroeconomic, sectoral, and structural issues. Anti-poverty imperatives play an important role, even as the emphasis is on broader national programs. Technical assistance is now incorporated in aid programs, rather than stand alone, which was the practice of Point Four. And, as foreign economic aid appropriations decline as a proportion of U.S. gross national product, the emphasis on creating a climate for private capital flows has increased.

There are philosophic, practical, and operational reasons for using different techniques of foreign economic assistance. The role of U.S. foreign assistance, and the instruments used, must also take account of the operations and techniques of the multilateral financial institutions in which we participate and whose fund availabilities and developmental influence now exceed those of the U.S. bilateral program. The next section of this paper examines the context (as defined above) in which the U.S. foreign aid program now functions. Section III analyzes the advantages and disadvantages of different aid techniques, putting these into historical context. Section IV is a discussion of the role of bilateral U.S. policy-based assistance at this time. Section V contains conclusions.

II. Current Context

A. Limits on AID Discretion

Those who make policy for bilateral economic assistance must deal with the evident fact that concessional resources are static (diminishing in real terms), but the magnitude of the financing problem of developing countries is growing. This means that the external financing task must be left mostly to others - private flows and the international financial institutions. The U.S. foreign aid program in these circumstances must first define and then build on its own areas of expertise. These circumstances do not exclude policy-based assistance, but do circumscribe their nature.

It is this search for the U.S. comparative advantage that dominates the analysis and recommendations of the task force on foreign assistance of the House Committee on Foreign Affairs (Committee on Foreign Affairs, U.S. House of Representatives: Hamilton-Gilman Report). This report identifies the external debt problem as the principal development obstacle (p. 25), but makes no recommendation that the bilateral program deal with this. Instead, the report proposes that the United States exploit its strengths: "private enterprise, education, science and technology, and non-governmental organizations" (p. 25). AID's own analysis comes to a more or less identical conclusion, that government programs can play a supporting role "at best," and the major developmental contribution of the United States must be in its own domestic economic dynamism and the contribution of its private sector (Agency for International Development, p. 121).

This is a major contextual change from earlier decades. The United States was practically the only aid giver in the immediate postwar period, providing vast resources to Europe under the Marshall Plan (some 2-3 percent of U.S. GNP) and to Asia. Aid as a proportion of GNP was still more than I percent in the early 1960s, the period of the Alliance of Progress (Heginbotham and Nowels, p. 19). These were years of

dominance of policy-based lending.[1] U.S. foreign economic aid today is less than 0.3 percent of GNP.

Another important aspect of the current context is the narrow concentration in value terms of U.S. economic aid in the Middle East (Israel and Egypt) and Central America (El Salvador in particular). Almost all economic support funds (98 percent) and half of development assistance are earmarked (Committee on Foreign Affairs, U.S. House of Representatives, p. 27). The funds over which AID has discretion are limited. The ability to influence the policy of aid recipients must therefore come less from the leverage of conditionality and more from the power of persuasion.

A final element of context that will be noted here is the large role now played by the international financial institutions, particularly the International Monetary Fund and the World Bank, in inducing changes in macroeconomic and structural policies of developing countries. Their influence comes from expertise, and the leverage of their own resources and those opened when countries conclude programs with them. They operate in debtor countries in which the United States has no full-fledged aid programs, e.g., Argentina, Brazil, Mexico, and Venezuela. These institutions are thus able to deal directly with obstacles to development in countries in which the United States has major economic interests, whereas AID has only a marginal role in these places.

B. Other Actors

Donors other than the United States do not normally engage in policy-based lending in their bilateral programs. Emphases vary among these programs from altruism to export promotion, including mixing aid and non-aid funds for this purpose. When other countries wish to influence macroeconomic policies of aid recipients, the normal pattern is to do so via multilateral channels. Some donors - France comes to mind - retain much influence over policy in former colonies, but less through outright aid

programs than because of currency linkages (such as that of the CFA franc in Africa with the French franc) and the use of nationals in policy positions in aid-recipient countries. Policy-based lending as practiced under the Alliance for Progress involved the leverage of large resource transfers, coupled with pretensions of hegemony. Few, if any, donor countries now meet these preconditions.

The IMF has engaged in policy-based lending from the beginnings of its existence. Perhaps no other feature of IMF practice has entailed as much controversy and hurling of epithets as conditionality. Conditionality refers to practices and procedures governing the use of Fund resources (Guitián, p. 1). Conditions imposed by the Fund have evolved over time, but conditions there have always been.

The purpose of this essay is not to examine the practice of Fund conditionality, but it is necessary for AID to be informed about what the Fund is doing in devising its own programs. The Fund is normally called upon when a country faces severe macroeconomic problems, either excessive inflation or an unsustainable deficit in the balance of payments, or more likely both. Fund correctives for these problems tend to focus on a few central macroeconomic targets designed to reduce absorption (private consumption, domestic investment, and government spending) on the demand side, and to promote expenditure switching to encourage production on the supply side (Research Department of the International Monetary Fund).

Because its programs are essentially short term, the increased production that is the ultimate objective may be delayed until after the expiration of the Fund intervention, or may never come. The main criticism of Fund programs tends to be that its correctives generally bring immediate hardship; or, in a more sophisticated formulation, that the transmission mechanism from intermediate targets dealing with fiscal, monetary, and exchange-rate policy, to ultimate targets of increasing savings and investment, and overall growth, do not necessarily work as the Fund postulates.

There will be a brief discussion of these charges later. For now, the relevant observation is that if dealing with problems of external indebtedness is the main challenge of the development community, the Fund is an indispensable agency. A criticism levelled against the Fund by outside observers is that it has not dealt sufficiently with the debt problem; or, rather, that the countries that make resources available to the Fund, have not been generous enough to permit Fund management to attack the debt problem head on. The Fund has taken some actions, however. One is to establish two facilities for its low-income members, a structural adjustment facility (SAF) and an enhanced structural adjustment facility (ESAF), which derives resources from the SAF and special loan and grant contributions, to provide balance-of-payments assistance on concessional terms (*IMF Survey*, September 1988, p. 12). These facilities are being used more than the regular stand-by facility.[2] One of their features is the preparation (in theory by the country, with the aid of the Fund and World Bank staff) of a policy framework paper dealing with stabilization and structural issues, which has become a coordinating instrument for the two institutions.

The Fund has also sought to exert pressure on commercial bank creditors to participate in debt rescheduling exercises either by making its own resources contingent on debt relief by the commercial banks or providing resources directly for use in debt reduction actions.

The World Bank was established to provide project loans, not to engage in policy-based lending. However, starting in 1980, the Bank initiated its own version of policy-based lending called structural adjustment loans (SALs) and subsequently sectoral adjustment loans (SECALs). The immediate reason for this change was the sharp deterioration in the terms of trade of many developing countries, particularly from the second oil shock. As with the Fund, this lending is intended to achieve stabilization ("managed reductions in expenditures to bring about an orderly adjustment of domestic

demand to the reduced level of external resources") and structural adjustment ("changes in relative prices and institutions designed to make the economy more efficient, more flexible, and better able to use resources and thereby to engineer sustainable long-term growth") (Country Economics Department, World Bank, p. 1). These adjustment loans made up almost 25 percent of total Bank lending in 1988 (Thomas and Chhibber, p. 28).

As with the IMF, the results of the World Bank's policy-based lending (Bank literature tends to refer to this as adjustment lending) will be discussed briefly later. The important point is that the Bank is engaging in such lending after resisting for more than 30 years. Like the Fund, the Bank's adjustment lending contains its own conditions, either macroeconomic or sectoral. (It is interesting to note that the Bank is following a path similar to that of AID in the 1960s, of using quick-disbursing lending conditioned on macroeconomic variables, and then branching out into specific sectors after concluding that adjustment and development have their sectoral and micro in addition to macro elements.)

The United States, which before this decade opposed non-project lending by the World Bank, has so thoroughly shifted position that one of the conditions for agreeing recently to the capital increase of the Inter-American Development Bank was that it support the policy-based lending of the World Bank and at some point presumably engage in its own lending of this type. To cite the U.S. Secretary of the Treasury: "In particular, we expect the Inter-American Development Bank, now that agreement has been reached on a capital increase, will undertake programs that encourage its borrowers to adopt policies that will contribute to their economic recovery." (Brady, June 15, 1989)

C. U.S. Resources

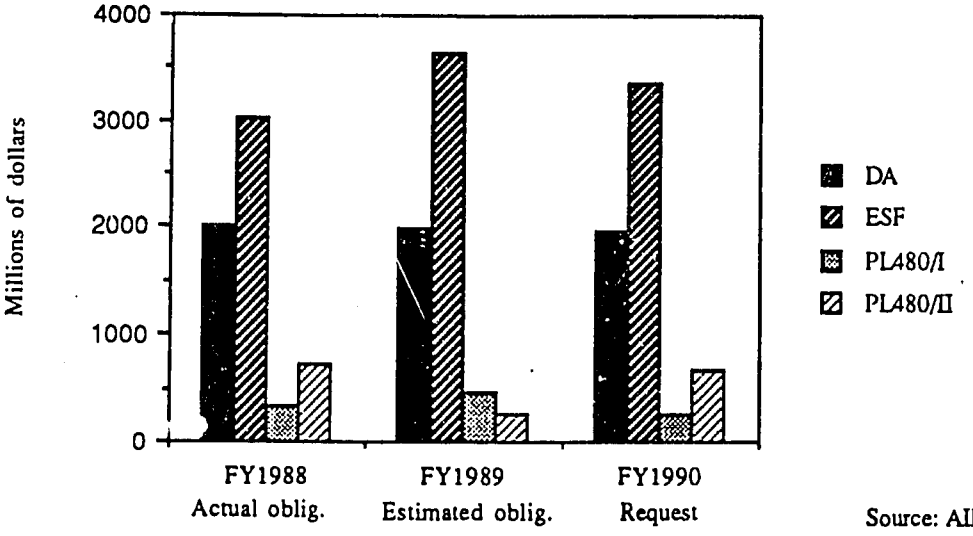
One element of context that should be highlighted is the resources available to AID to engage in policy-based lending of a macroeconomic nature. Figures 1 and 2 show recent AID obligations (or for FY1990, the AID request).[3] Several features of these figures merit mention.

The first is that the total figures are modest, between $6 and $7 billion for the entire economic assistance program. In its fiscal year 1987/88, the World Bank's program (the IBRD and IDA) was $18.4 billion in loans extended and $15 billion in disbursements, of which about one-quarter was adjustment lending (*IMF Survey*, September 26, 1988, p. 297). The IMF is a revolving pool of currencies and its lending totals cannot be compared directly with those of development institutions, but some idea of the magnitude of its operations can be obtained from its total funds outstanding. As of April 30, 1989, these were SDR 6.6 billion (about $8.2 billion), and the undrawn balance of agreements in existence was SDR 3.7 billion (about $4.6 billion). (*IMF Survey*, June 12, 1989, p. 185) The IMF figures understate the influence of the Fund in opening other sources of foreign funding when it enters into a program with a country.

The second is that even these figures overstate what is available to AID for insisting on macroeconomic policy conditions. Of the obligation or request data shown in figure 1, only the ESF portion lends itself naturally to macroeconomic policy strictures. Development assistance focuses on projects and sectors and PL480 on agriculture, and their conditionality must therefore be more focused.

The third is that even ESF is not generally suitable for setting macroeconomic conditions because of earmarking. These funds are used primarily in countries where the United States has important political or military interests which generally override conditionality relating to budgets, monetary policy, or the exchange rate. The

Figure 1
AID Economic Assistance

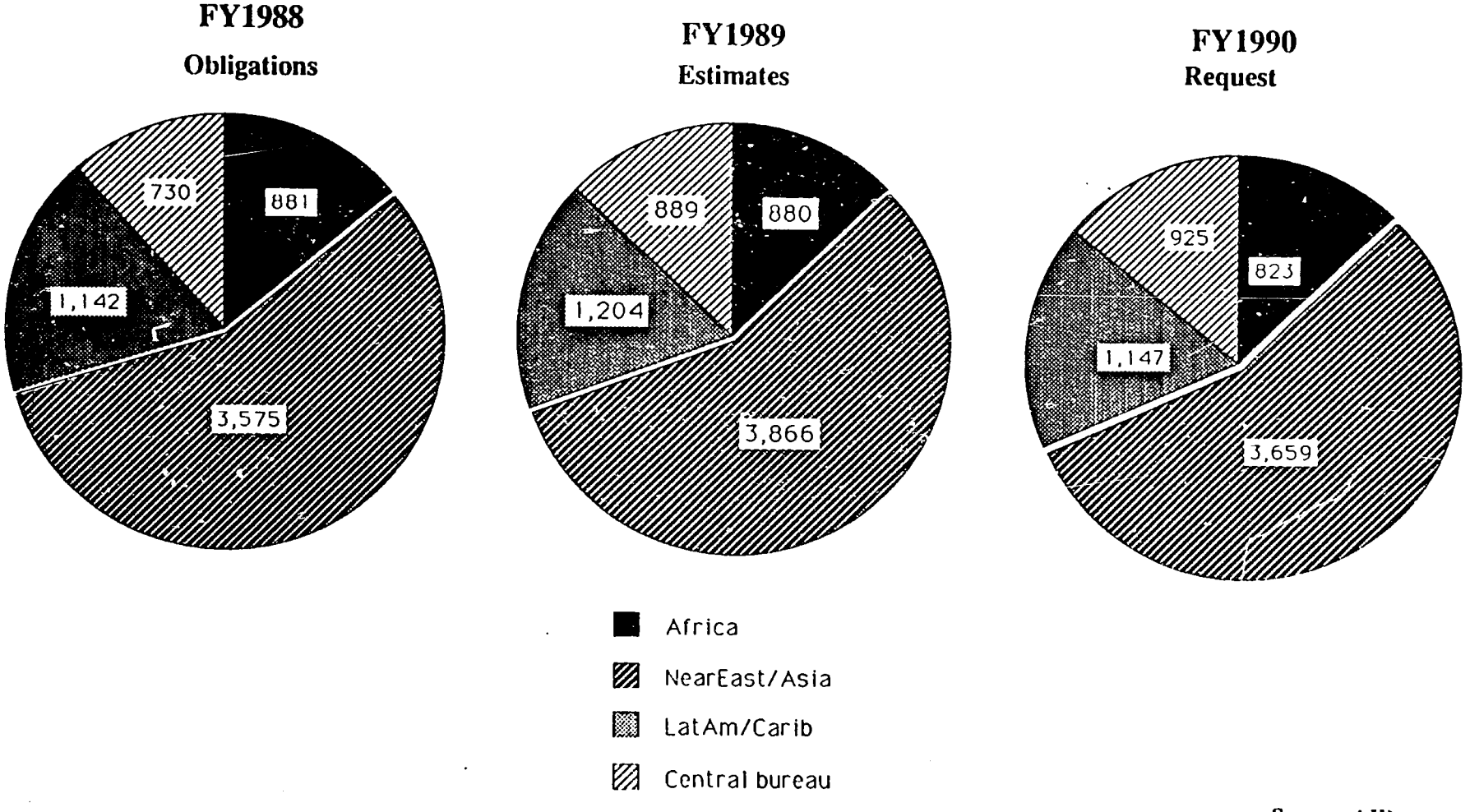


Source: AID

Figure 2

Aid by Regions

millions of dollars



Source: AID

countries know this and therefore the leverage runs from country to the AID authorities, rather than the reverse (Vondal).

This does not mean that AID cannot engage in policy-based lending, but rather that it must tailor its policy conditions to the reality of AID programs. It makes little sense for AID to seek to replicate the macroeconomic conditions of the Fund or the World Bank, but this still leaves ample scope for narrower conditionality. These theme will be taken up later.

D. Philosophic Emphases of the Different Actors

The final element of context that will be discussed here is perhaps the most crucial -- namely, what does each actor, including AID, hope to accomplish in its program of economic assistance. The objective(s), assuming it (they) can be defined, should determine the content of economic assistance programs.

The IMF mandate is probably the most straightforward of the major actors, but even here there is some ambiguity about the Fund's responsibility for secondary consequences of its programs. The Fund's legal responsibility pertains to a country's external balance, and it has always necessarily concerned itself with internal macroeconomic measures that affect this balance. However, Fund thinking has gone through some transformation in recent years with respect to its responsibility for the internal social effects of its programs. As recently as 1983, a senior official of the Fund asserted that it was not the Fund's responsibility to concern itself with issues of basic human needs or income distribution; the authorities of the country were the sole judges of a nation's social and political priorities (Finch, pp. 77-78). In 1987, the managing director of the Fund stated that "within its mandate and its possibilities," the Fund has given steadily greater attention to the social aspects of economic policies in its programs (Camdessus, p. 195). This shift is also evident from the Fund's own

studies cited in the bibliography to this paper which deal with the effect of Fund programs on poverty and income distribution.

The general objective of the World Bank, to promote development, is straightforward, but the means used have also altered over time. The introduction of adjustment lending has already been mentioned. The philosophy of the "management of development" was set forth in some detail in the 1983 *World Development Report*, which laid out a stress on "efficiency" in resource allocation based predominantly on markets and only selective government interventions (World Bank). The Bank, like AID, went through a period in the 1970s when it stressed poverty alleviation, but it never did so as singlemindedly, to the exclusion of of the overall economic setting in the countries in which it was engaged, as did AID under the New Directions.

The objectives of U.S. economic assistance have been both more variable and more nebulous than those of the Bank and Fund.[4] At the most general level, it is not too difficult to define the objective(s) of U.S. foreign economic assistance. AID has recently defined these simply as a "vital set of political, economic, and humanitarian interests in the so-called developing countries," but really made no great effort to relate these to the AID program (Agency for International Development, p. 1). The Hamilton-Gilman report is not much more precise. Foreign assistance, it asserts, should promote the "political and economic stability" of nations important to the United States by stimulating economic reform and growth, and by responding to U.S. humanitarian concerns (Committee on Foreign Affairs, p. 24). Reports on foreign assistance over the years contain comparable general language (Brookings Institution, 1951 and 1977; Commission on Security and Economic Assistance; and Task Force on International Development).

The philosophy that gives content to these generalities and which tries to relate objectives to AID operations emerges in the details of programs. Thus, the Alliance

for Progress, despite the grandiose language of the Charter of Punta del Este, emphasized policy at the macroeconomic level; the New Directions, meeting basic human needs and alleviating extreme poverty; the Carter administration, the promotion of human rights; and Hamilton-Gilman some vague synthesis among economic growth, poverty alleviation, protecting the environment, and promotion of pluralism. The different emphases define the conditionality that accompanies AID programs, whether macro or micro, social or economic, political or growth oriented. All aid is thus policy based, but the target variables differ with the times. The current philosophy (at least as defined in Hamilton-Gilman) seems antithetical to policy-based assistance conditioned on broad macroeconomic variables, but rather narrower conditioning in the poverty-environment-pluralism areas.

III. Strengths and Problems of Different Aid Techniques

A. Some Theoretical Considerations

The choice of different aid techniques has tended to be both fortuitous and episodic. The Marshall Plan, as we know, grew out of concern over Soviet expansionism, and the Alliance for Progress, over fears that some version of the Castro experience in Cuba would be replicated elsewhere in the hemisphere. In each case, these anxieties called for rapid results. It is not surprising, therefore, that the aid technique chosen was one that involved quick-disbursing funds, and this required non-project aid of a program nature. The introduction of Point Four in President Truman's inaugural address in 1949 was an outgrowth of congressional antipathy toward appropriating funds for foreigners (Baldwin, p. 61); and it was important also to find an initiative that did not entail large appropriations to include in a major presidential address.

None of these programs should be criticized because they grew out of special circumstances; they should be evaluated on the basis of their accomplishments. However, their use does illustrate that practice is a consequence of circumstance, and theory often a rationalization of the practice that circumstance dictates.

The shift away from the pure Point Four approach came about when it was evident that technical assistance was not enough for stimulating development without accompanying funds (Nelson, p. 3). Rutherford Poats has referred to the "naive optimism" of Point Four, that the United States could transfer knowledge and techniques to diverse developing areas with little prior research or adaptation (p. 8). There is little quarrel among aid practitioners today that the correct approach requires a melding of appropriate technical assistance and other resource transfers.

The choice between general program and project assistance has a less clearcut theoretical consensus. The World Bank engages in both, but weighted three to one in

value terms in favor of project lending. Even when introduced, the World Bank anticipated that adjustment lending would last about three years; it has endured to this day because the environment that led to its introduction has persisted, indeed worsened. The standard argument is that project lending, if the project is well chosen, leaves behind a tangible, needed accomplishment, whereas dealing with an entire program is the responsibility of the national government.

There is a contrary theoretical position, however. If foreign aid enters into the total stream of fungible funds available to a government, the projects most likely to be funded will be the marginal ones; and because of local currency requirements, these relatively low priority projects are apt to take resource away from what may be more pressing needs, such as education and health care (Meier, p. 302). The case for general program aid is the corollary, that this type of assistance permits the recipient to integrate the resources into the nation's total plan.

B. Conflicting Assessments of Policy-Based Lending

The literature on IMF policy-based lending is extensive. Many of the leading studies are cited in the bibliography. World Bank adjustment lending is more recent and there are fewer evaluations; the most comprehensive is that of the World Bank's Country Economics Department. Analyses of AID's macroeconomic policy-based lending are less systematic than of Fund and Bank programs. There is much disagreement in evaluations of policy-based lending of all three institutions. What is lacking is a public literature on bilateral lending with policy conditions less sweeping than on the macroeconomy. The experiences of AID practitioners recounted in Vondai is therefore extremely valuable.

Evaluations of the outcomes of policy-based lending are inherently complicated. They permit assessment of the results of actions taken, but no comparison, other than

by simulation, of other measures that might have been chosen. This point is made repeatedly in the evaluations cited in the bibliography. Beyond this, evaluators bring biases and this inevitably colors judgments. For example, one of the early criticisms of the Alliance for Progress, that by Levinson and de Onis, makes much of the fact that policy conditions were macroeconomic and failed to deal sufficiently with social problems. "Loan officials have consistently required that countries seeking financial assistance undertake monetary stabilization programs; they have not required programs of social reform." (p. 14) There clearly was a conflict of outlooks, whether outside pressure accompanying resource transfers should put pressure on national social matters in addition to economic issues.[5]

Observations on the Alliance merit some discussion because they illustrate the sharp divide on the appropriateness of broad macroeconomic conditionality. The criticism of this approach is not absent when imposed by the international financial institutions, *viz.*, the persistent attacks against the IMF, but the sensitivity is greatest when this conditionality is practiced bilaterally.[6]

One of the early criticisms, that of Hirschman and Bird, was that program lending, by imposing conditions on the most vital economic areas of a recipient country, involved arm twisting and replacing the judgment of officials of the donor country over those of the recipient (p. 14). They argued that by altering relative prices (the exchange rate and interest rates to promote savings and investment over consumption), programs favored one group over another. What they were saying in essence is that program aid does have a social content, but one that enters through the back door.

The theme of intrusiveness of macroeconomic policy-based lending is ubiquitous in criticisms of the Alliance. Some quotations illustrate this point.

> Nonetheless, the Alliance assumption that the offer of external assistance can provide an effective inducement for a country to adopt basic policy changes and reform still appears to retain considerable vitality in U.S. assistance strategies and negotiations. Since the Alliance experience can

> be interpreted as an overwhelming repudiation of the general efficacy of this assumption, its continued vitality is striking (Heller, p. 135).
>
> The assumption that the intervention of an external invisible hand in the development process can influence the intensity of social change conflict (sic) is at best a liberal and naive dream (Wionczek, p. 136)
>
> [Intervention] means the United States is always telling other countries what they should do and trying to get leverage to push them to do it...the Alliance was, on balance, good intervention. But it did not work out (Urquidi, p. 201)
>
> The disparagement of Latin America and its leadership, and the belief that Latin America couldn't or wouldn't do anything on its own, had deep roots in the United States (Wiarda, p. 104)

But there is another side to this story of the Alliance, as illustrated by the following quotation from a Colombian official:

> The results of this coordinated effort are impressive. Colombia received loans that made economic growth possible, while the 1967 reforms began creating the conditions for export growth. In addition, the foreign resources also made possible a major structural change in the economy (Urrutia, p. 200).

I have my own view of the value of the Alliance. It is captured in a citation from Scheman, that it unleashed "enormous forces of creativity" in the hemisphere (p. 7)[7] However, the Alliance itself is not the issue at hand, but rather the efficacy of placing macroeconomic policy conditions on bilateral aid. The issue is mostly moot for reasons already stated. Therefore, the issue for now can be restated: Can the United States impose other policy conditions, those which are less sweeping than the earlier macroeconomic ones, on the use of its aid resources? The answer to this must be yes, else why provide U.S. taxpayer resources. The question thus reduces itself to the kinds of conditions and the manner of their imposition. This will be the theme of section IV.

A few words on the effectiveness of IMF and World Bank policy-based lending may be useful. There are evident differences between their conditionality and that of a bilateral lender. The most important is that the international financial institutions do

not have political interests in recipient countries that override compliance with macroeconomic conditions, whereas the United States frequently does. Geopolitics (Egypt, Israel, Central America are examples), the desire to retain military bases (the Philippines is an example), and the promotion of democracy (Central America is again a good example) are some of these. Another is that country resentments directed at international financial institutions (both words, international and financial, are important) do not have the same resonance as those targeted on a bilateral donor. And, finally, it is rare to argue the case against macroeconomic conditionality as such when imposed by the IMF or the World Bank; disagreements, where they exist, revolve around the nature and extent of the conditionality. As is evident from the quotations given above criticizing conditionality under the Alliance, the argument is that a bilateral donor should not have the gall (chutzpah is a better word) to impose macroeconomic conditions on an aid recipient - period.

World Bank adjustment lending is closest in kind to AID program lending. Both are directed at long-term development, use quick-disbursing funds, and concentrate their conditions on similar types of macroeconomic variables. AID had about half a dozen years of experience with program lending; the World Bank has now had more than eight years of experience with adjustment lending. The economic results of World Bank lending are, at best, ambiguous. By one measure, at the completion of disbursement about 60 percent of the policy changes agreed to as conditions of SALs and SECALs had been fully implemented (McCleary, p. 32). The most successful areas in this respect have been in exchange-rate management, energy policy (especially pricing), agricultural pricing, financial reforms, and public sector expenditure programs. Policy change has been less forthcoming for industrial policies, tax reform, and public enterprise reform. A tentative conclusion is that policy conditions are more likely to be met on pricing matters, including the exchange rate, and less likely where

institutional change is required (McCleary, pp. 32-33).

The World Bank study on this subject compared 30 countries which received adjustment lending with countries not receiving such loans on nine indicators and concluded that the adjustment lending countries improved compared to non-adjustment lending countries in 54 percent of the cases (Country Economics Department, p. 24).[8] This is not a comprehensible figure because it mixes intermediate with final targets (for example, performance on a debt/export relationship target and one on GDP growth); and the time elapsed is too short for meaningful assessment. The main conclusions highlighted in the World Bank study is that relative growth performance improved for countries receiving adjustment lending; they had stronger real depreciation; inflation came down for about half of them; their budget performance was uncertain; external debt indicators improved for about half of them; and, finally, perhaps ominously, the burden of adjustment fell heavily on investment (p. 24).

One feature of policy-based lending familiar to World Bank structural loans, IMF conditionality, and AID programs is the ability to withhold disbursements when targets are not met. There were cases when disagreements held up disbursements during AID's period of program lending in the 1960s. The issue was quite intense in Colombia in 1966 and 1967 before agreement was reached on exchange-rate policy. PL480 aid to India was withheld in 1965-1966 because of disagreement over agricultural policy. Crises over meeting conditions and withholding disbursements are particularly sensitive in bilateral lending for evident political reasons. Close to three-quarters of adjustment lending tranche releases were delayed by the World Bank because of alleged failure by the country to meeting loan conditions, but almost all tranches were released eventually (Country Economics Department, p. 7).

A central conclusion of the World Bank study is worth citing verbatim:

> The debt overhang, the global economic environment, and the problems of improving national economic management are such that the need for

> structural adjustment actions seems certain to continue for some time. Adjustment lending, however, is both a potentially high pay-off and high risk investment. There is, therefore, the need to continue adapting and improving the policies and procedures of structural adjustment lending to increase its effectiveness (p. 9).

IMF programs constrain demand in the short term in the interest of what is hoped will be overall growth in the medium to long term from the stimulus on the supply side of the economy. Whether in fact this growth does follow in due course is hard to determine because underlying conditions and policies may change in the interim. It is generally agreed, even in the IMF's own studies, that tighter monetary and credit policy does lead to an initial decline in the growth rate (Khan and Knight, p. 24; and Guitián, p. 31). Studies show no clear empirical relationship between overall growth and fiscal policy. But the studies do show a positive relationship between the growth rate and capital formation (Khan and Knight, p. 24). This is why the finding by the World Bank that investment declined in adjustment lending countries is legitimate cause for concern.

Because the Fund's programs are intended to have an absorption-constraining effect in the short run, there is a strong case for coordinated effort between the Fund and other donors. This is particularly important because the Fund's direct injection of resources is rarely substantial. Coordination among donors is evidently desirable. Almost all the countries that received Bank adjustment lending also received Fund credit. The coordination between the two institutions was not always as close as it has been in recent years.

AID's contribution in this coordinated stabilization-adjustment effort will vary by country. At times it will be substantial in resource terms, as is contemplated as this is written for the multi-year program in the Philippines; at other times it will be modest. But AID can never ignore the programs of the multilateral institutions in countries in which it operates.

C. Undesirable Side Effects of Policy-Based Lending

The main substantive criticism levelled against the Alliance for Progress (that is, other than those which argue that U.S. officials should not have imposed their judgment on local authorities) was that by focusing on macroeconomic variables, it ignored the needs of large segments of the population in recipient countries. The backlash was strong in the New Directions policy of AID. The critical world financial situation has now brought on another backlash, this time directed against poverty-based programs because it has become evident that these made only a small dent, if any, in reducing the number of people who live in poverty. John Lewis has concluded that policy-based lending is here to stay, and since the poor have a better chance of improving their situation under circumstances of economic growth, the anti-poverty fighters should not strive for exlusivity. But Lewis also makes the point that "adjustment 1980s-style has been harsh in its impact on the poorest sections of developing-country populations [and] therefore needs cushioning and supplementing." (p. 23).

IMF and World Bank studies hedge on the issue of how the poor are affected by stabilization-adjustment programs. Several IMF studies argue that stabilization can play a constructive role in this regard because the poor are generally in a bad position to protect themselves against implicit tax burdens of inflation and black markets and suffer most from joblessness in an unstabilized economy (Heller and others, p. 32; and Fiscal Affairs Department of the International Monetary Fund). The latter study argues that there is little reason to believe that Fund-supported adjustment programs lead to any increase in income inequality, compared with what would happen without these programs (p. 37) However, the first study cited concedes there are many situations where stabilization-adjustment has had significant adverse effects on vulnerable groups,

for example, devaluation as it affects the urban poor producing nontradables and the rural poor where ownership is concentrated or where supply elasticities are low, and cuts in health and education expenditures (p. 33). This study does not suggest any alteration in demand-limiting stabilization policies, but rather compensatory measures to alleviate what are expected to be short-term hardships, such as targeting subsidies and social expenditures more directly toward the poor.

The World Bank study on adjustment lending notes that the economic difficulties of the 1980s have slowed progress on nutrition, infant mortality, life expectancy, and primary school enrollments, but then argues that most of these indicators were better in the 1980s for countries receiving adjustment loans than in the 1970s (Country Economics Department, p. 30). The approach taken in the World Bank study is that it is necessary to identify where the poor are located, country by country, in order to analyze how they are affected by adjustment lending in order to be in a position to take remedial measures.

It was noted earlier that there has been some change in IMF thinking; the Fund is not quite prepared to admit that its programs adversely affect the poor compared with the situation if there were no program, but it no longer insists that poverty and distribution issues are none of its business. The Bank has concerned itself with poverty issues for some time, but its position on adjustment lending is comparable to that of the Fund - that the situation would be worse without the lending and what is needed is the lending plus some pinpointed remedial measures.

IV. Role of AID Policy-Based Assistance

The assessment in this paper starts from the assumption that AID, with rare exceptions, lacks the resources and flexibility to set macroeconomic conditions in its policy-based lending. Even where AID is providing substantial economic resources, as in the Philippines, this is best done cooperatively with other donors, bilateral and multilateral, which limits AID's discretion in setting global conditions. This is likely to be the pattern in other countries, for example, if a substantial stabilization-adjustment program is launched when and if Peru achieves a new government.

Another assumption is that macroeconomic conditionality is best established by the international financial institutions, ideally in a coordinated way by the IMF and the World Bank (with the possible addition of regional development banks in the future), and further macroeconomic conditions by AID would be redundant. It is also undesirable for AID to be seen as an appendage of the international institutions. AID's programs and conditions should be complementary but clearly distinguishable. The rationale for a bilateral U.S. economic program is to support themes that are seen as distinctly American rather than be an echo to the international bodies; otherwise, why have a bilateral economic program at all?

AID's programs and conditionality should emphasize those areas of perceived U.S. comparative advantage. Hamilton-Gilman attempted to define these: growth; environmental sustainability; poverty alleviation; and pluralism. While promoting economic growth is hardly a unique province of U.S. aid, the twist put on this by Hamilton-Gilman is that growth must be broad-based in order to reach the poor and support more open economic systems.

I do not wish here to define the areas of U.S. expertise; the Hamilton-Gilman areas are broad enough to encompass specific areas, such as health and education.

Hamilton-Gilman and Vondal also note some other aspects of relative AID expertise. These are the presence of AID missions in countries, which has permitted AID officials to develop detailed knowledge of the local political and social milieu and of particular sectors. AID officers are likely to know key actors in the areas in which the program is engaged. By being on the scene, AID officials haved the ability to carry on a continual dialogue without making a big deal out of a special visit from headquarters in Washington, D.C. These are important assets, perhaps unique among official donors, bilateral or multilateral. They permit the setting of sectoral and social conditions in AID programs that have good prospects of being achieved. The implication of this conclusion is that AID personnel policy for staffing its missions should stress area and sectoral knowledge. The constant shifting of AID personnel from country to country and region to region to avoid "clientitis" is apt to weaken AID's effectiveness.

It has become a truism that foreign aid conditions are more likely to be met when devised in collaboration with host country officials rather than imposed from the outside. IMF documents constantly repeat the theme that programs are not those of the IMF, but of the country. "But allow me again to make the point that adjustment programs are not Fund programs, only Fund-supported programs." (Camdessus, *IMF Survey*, June 26, 1987, p. 195). This does not mean accepting naively what host country authorities propose, but it does imply knowing when host-country agreement is given whether the intent is to comply or to evade. It is not hard to evade. Those of us who have observed evasions of IMF conditions can cite chapter and verse of how this is done. The World Bank study of adjustment lending states between the lines that targets were not originally met in three-quarters of the cases; the subsequent release of tranches thus must have involved a negotiated process to define compliance.

AID's constant presence in-country, coupled with knowledge of the local scene,

facilitates cooperation with host-country actors. AID conditionality therefore does have the ability to be realistic.

The issue of coordination with other donors is particularly important if AID is to focus on areas and issues tailored to its talents and strengths. Part of coordination is to avoid overloading the time of busy host-country officials (Development Assistance Committee). Another is to make sure that different programs are in fact complementary and not inconsistent. My own sense is that AID can be more effective in certain areas than either the IMF or the World Bank. These include poverty alleviation, including the compensatory policies raised in IMF and World Bank discussions of the distributional effects of its stabilization-adjustment programs; and in the promotion of pluralism, which the international financial institutions ignore on the grounds that politics are outside their mandates.

The various studies only hint at potential areas of compensatory policies. These include more targeted programs directed to the affected poor when agricultural, gasoline, and other prices are increased on macroeconomic grounds; focusing on the provision of health services curtailed when broad stabilization programs entail cutbacks in budgetary expenditures in this area; and provision of credit to small entrepreneurs to counteract the micro effect of credit curtailment under stablization programs.

Compensation is possible only when it is clear which groups bear the brunt of stabilization-adjustment programs. This analysis is rarely carried out by the persons devising these programs; their interest is macroeconomic. AID missions are far better situated to understand the distributional aspects of broad programs, but only if they know the details of the programs at the time they are negotiated. This can be a crucial aspect of AID programs, and requires AID involvement from the outset of stabilization-adjustment programs and not just picking up the pieces after the programs are in operation.

AID, on occasion, delayed disbursements in its period of program lending; it never, as far as I know, completely terminated programs because economic targets were not met. This, largely, has been the World Bank experience as well with adjustment lending. The complete cessation of a broad stabilization-adjustment program because of economic disagreement is a major step. The termination of less comprehensive programs, whether sectoral or compensatory in the sense discussed above, is less cataclysmic. AID should obviously not enter into programs with the expectation of later conflict and termination, but the possibility of escape should not be closed off.

While termination of bilateral programs because of economic disagreement is rare nonexistent, programs have been stopped on political grounds. Nicaragua comes to mind. Programs were delayed during the Carter administration on human rights grounds. Hamilton-Gilman stresses pluralism. This form of political conditionality is feasible bilaterally. It is not multilaterally, as we learned from experience during the Carter administration when we sought to impose our human rights standards on the international financial institutions. This form of conditionality - on political or human rights grounds - is thus entirely appropriate for AID.

AID can have a good deal of policy influence in host countries, even if not necessarily on the macroeconomy. This comes about not just from the provision of resources, although this is not negligible, but from the desire of countries to have good relations with the United States. AID is not a surrogate for other U.S. economic policies, but AID's active presence does influence U.S. investors and subsequently U.S. trade flows. Political conditions set in AID programs are a manifestation of AID speaking for the U.S. government as a whole, and can thus be quite powerful in promoting U.S. desires for pluralism in AID-recipient countries.

V. Conclusions

The position set forth in this paper is that the principal role in stabilization-adjustment programs, and hence in establishing macroeconomic policy conditions, must be played by the international financial institutions, particularly the World Bank and the IMF. This is because they have the resources to play this role and the resentments inevitably aroused when demand must be curtailed are more easily diffused when directed at some impersonal international agency than at the United States. Other countries eschew bilateral aid programs conditioned on macroeconomic policy changes for precisely these reasons. The United States was more apt to enter into bilateral macroeconomic policy-based lending in earlier periods, when we were the main provider of aid resources, but this time has passed. We still have some control over macroeconomic conditions imposed in IMF and World Bank stabilization-adjustment programs from our participation in these institutions, but our role is now indirect rather than frontal. We have some control also when we participate as one party in foreign aid consortia or consultative groups, but not as complete if the conditionality were imposed by us bilaterally.

We have come to this position from an historical evolution. Our economic assistance programs to developing countries grew from the small beginnings of technical assistance under the Point Four period, to modest official lending on concessional terms in the late 1950s, to substantial lending and involvement in setting macroeconomic conditions during the first half of the 1960s. Since then our economic assistance programs have diminished in scope, and the flexibility available to carry out these programs has been severely constrained by the Congress. AID could not effectively impose macroeconomic conditions in its programs in most countries even if it wished to do so because congressional earmarking has removed the credibility to do this, and other political interests we have in countries tend to be overriding.

The issue, however, is not macroeconomic conditions or no conditions. The provision of concessional aid presupposes some conditions. They can be non-economic, such as on human rights and pluralism. They can be economic at a sectoral or even more micro level. They can complement the macroeconomic conditions of the international financial institutions, such as by easing the burden of stabilization-adjustment programs on the poor. In other words, policy-based lending by AID can play a multiple economic-political-social role.

The argument in this paper is that AID should play this role, that its policy-based lending should be built by exploiting AID's areas of comparative expertise in carrying out the objectives of foreign economic assistance - its presence in country, knowledge of the local milieu, sectoral skills, and above all, its role as the arm of the U.S. government in fostering economic development.

Notes

1. One of the attractions to the Congress of the basic human needs approach, in my judgment, was that it implied lower foreign aid appropriations.

2. As of April 30, 1989, there were 14 stand-by agreements outstanding, compared with 23 SAF and 7 ESAF agreements. The value of the outstanding stand-bys exceeded those of the SAFs and ESAFs combined, SDR 3.1 billion (about $3.8 billion) compared with SDR 2.6 billion (about $3.2 billion). (*IMF Survey*, June 12, 1989, p. 185)

3. The figures from which the two figures were derived are not identical. Figure 1 contains programs other than country programs and also contains adjustments for Title I of PL480 not made in figure 2.

4. An article in *The Wall Street Journal*, on July 3, 1989, makes evident that Japan, now the world's largest aid donor in absolute terms, is having trouble defining the purpose of its foreign aid program (Lehner).

5. If I may be permitted an aside, when I was director of the AID mission in Chile in the mid to late 1960s, the advice received from the Chileans in charge of the agrarian reform program was that it was wiser for AID not provide funds directly for that, but the fungibility of resources from program lending permitted the authorities to deal with this sensitive issue in their way. When the Allende government later expropriated American-owned copper mines, many ultra-conservative Chileans supported the action as just retribution for U.S. complicity in the Frei government's seizure of agricultural lands.

6. Private banks have attempted at times to practice macroeconomic conditionality, as in Peru in the 1970s, but the experience has been less than fortunate.

7. On another personal note, my own experience was that, with rare exceptions, finance ministers and other key economic policy makers in program loan countries in Latin America did not resent the macroeconomic conditions, since they were normally negotiated in a give-and-take atmosphere. What they most resented - as did the AID officials as well - were the extraneous, non-economic conditions, such as additionality in commodity procurement. This forced countries to impose systems of import controls, while the very thrust of the conditionality was to open markets so that exports could be promoted.

8. The nine performance indicators were GDP growth, investment as a proportion of GDP, export growth, real exchange rate, current account balance as a proportion of

GDP, budget balance as a proportion of GDP, inflation, the relationship between the external debt and exports, and the debt service/export relationship.

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