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Foreign Assistance, Economic Policies and Agriculture in Central America

By Dale W. Adams*

The National Bipartisan Commission (Kissinger) recently argued for major increases in already substantial U.S. bilateral assistance to Central America. While Congress has yet to determine the magnitude and composition of this aid, the U.S. could be annually spending as much as several billion dollars there the next 5-10 years. Because of the importance of agriculture in this region, the effects of this increased assistance on rural areas and on rural savings capacities could be substantial. While some additional aid will go directly to agriculture through rural development projects and have positive effects, it is also possible that large amounts of aid might, at the same time, reinforce policies that damage agriculture far more.

In the following discussion, I explore how more assistance might reinforce exchange rate, food pricing, agricultural credit, and savings mobilization policies that harm agriculture. I am most concerned with how increased activities by the Agency For International Development (AID) and other donors might affect these policies in Central America. I wrestle with four questions: (1) Is agricultural development critical for the U.S. to accomplish its foreign policy goals in Central America (2) Will large amounts of foreign assistance adversely affect policies that strongly influence agriculture? (3) Are the current techniques used by donor agencies to influence economic policies effective? And, (4) are there better ways for donors to attempt to sway these policies?

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Importance of Agriculture. With six countries receiving U.S. aid in Central America (excluding Nicaragua), the magnitude of the assistance proposed might be overlooked. Together these six countries have 21 million inhabitants, only three million more than Peru. Even without the increased aid proposed by the Bilateral Commission, recent U.S. aid to Central America has been large (Table 1). If U.S. bilateral assistance to the area is only doubled in 1986 over 1984 and reaches one and a half billion dollars per year, this would amount to almost 75 dollars per capita, more than 12 percent of the per capita income in Honduras, and nearly six percent of the per capita income in Costa Rica (IDB). It would also be more than half of the gross domestic investment in these countries in 1982, and about 35 percent of the value of all their exports in the same year.

TABLE 1. U.S. Assistance for Central America, 1982-85

Country	1982	1983	1984	1985**
		(1,000 U.S.$)		
Belize	0	16,697	14,000	10,000
Costa Rica	31,540	184,159	153,100	180,000
El Salvador	154,573	198,785	281,304	290,000
Guatemala	8,182	22,311	21,612	75,000
Honduras	67,967	87,226	152,255	120,000
Panama	11,686	6,230	45,200	39,800
ROCAP*	13,130	19,399	42,900	198,600
	287,078	534,807	710,371	913,400

Source: Agency for International Development (AID), Congressional Presentation FY 1985, Annex III, LAC Vol. I. AID: Washington, D.C., 1983. Figures include Economic Support Funds.

* A regional development organization
** Preliminary amounts proposed by AID.

It should not be overlooked that U.S. aid will add to other bilateral and multilateral assistance: the InterAmerican Development Bank extended nearly $330 million U.S. in new loans to these six countries in 1982, while the World Bank lent $180 million in 1982-83. Assuming funding from other sources is not reduced as U.S. aid increases, the amount of assistance to the region over the next several years could be overwhelming.

Agriculture continues to dominate Central America where six in ten people live in rural areas, nearly a quarter of gross domestic product comes directly from agriculture, and farm products make up almost 70 percent of the value of exports (Table 2). In addition, the poorest people in these countries live in rural areas and they provide the roots and cover for most insurgency.

Few would argue that major problems in rural areas are being resolved in Central America. The rate of growth in agriculture during 1970-81 only slightly exceeded population growth rates in the region (Table 2). While urban, industrial, public works, and military efforts will receive most of the press coverage about development activities, the struggle for the hearts and minds of people in Central America will be won or lost by the pace of rural development. Driving people into heavily armed hamlets, a la Vietnam, or forcing them into large urban centers by depressing incomes, a la Egypt, are not appropriate for Central America options. I am convinced that economic policies will largely condition rural development in Central America, and that agricultural growth will be the main determinant of the success or failure of U.S. policy there. I am particularly concerned that economic policies affecting agriculture will receive too little attention by donors and governments as they manage larger amounts of aid. Agriculturalists seldom understand how macro economic policies affect their turf, while local policy makers and high level donor employees are often vague about how their decisions affect rural areas.

Foreign Exchange Rate. Because most exports from Central are agricultural, farm incomes are strongly affected by exchange rates. Farmers are taxed by exchange rates that are

TABLE 2. Central America: Population, Gross Domestic Product and Trade

	Population 1982 (Million)	Population % Rural	Gross Domestic Product Per Capita 1982 (U.S.$)	Gross Domestic Product % from Agric.	Gross Domestic Product Avg. Ag. Growth Rate 1970-81	Trade Agric. Exports as % of Total 1980	Trade Cereal Imports 1981 (000MT)
Belize	0.1	N/A	1,080*	N/A	N/A	N/A	N/A
Costa Rica	2.3	52	1,310	23	2.2	65	177
El Salvador	5.1	59	560	26	2.3	59	123
Guatemala	7.4	68	1,111	25	4.3	70	186
Honduras	3.9	62	610	32	1.9	81	144
Panama	2.0	44	1,759	10	2.0	67	89
Total (or Avg.)**	20.8	60**	966**	23**	3.0***	69**	719
Nicaragua	2.5	39	935	20	2.7	83	67

Sources: Inter-American Development Bank (IDB), *Economic and Social Progress in Latin America: 1983 Report*, Washington D.C.: IDB, 1984; World Bank, *World Development Report 1983*. Washington, D.C.: World Bank, 1983.

* For 1981
** Weighted Averages
*** Calculated using the average growth rate for 1970-81 and the GDP figures for 1981.

less than market rates. For example, if the official rate of exexchange is two-to-one, farmers selling export goods at this rate will receive only two units of local currency for every dollar earned from agricultural exports. When local currency is overvalued, farmers receive lower prices (in local currency) using the official rate of exchange than they would if the market rate were used. If the market rate is 2.5-to-one farmers who are forced to export at two-to-one effectively pay a tax of 20 percent of the value of their exports.

Rare is the low income country that does not have, at least occasionally, overvalued exchange rates; few countries adjust rates rapidly enough to avoid some distortions. Until recently this was less of a problem in Central America than in countries further south, but this began to change in the late 1970s. While difficult to pin down exact figures, exchange rates in Central America are currently overvalued by about 20-25 percent on the average, a tax of $600-$800 million per year on agriculture. (This ignores Nicaragua where rates are much more distorted.) I predict these distortions will increase with more aid.

There is no commandment that requires foreign assistance to cause or sustain overvaluation; most governments set their own exchange rates, and donor agencies are not likely to encourage them to distort these rates. Still, there are numerous cases where major amounts of foreign aid, large increases in foreign exchange earnings due to temporary product price increases, or increases in commercial foreign borrowing by a government have been associated with increased exchange rate distortions. All three of these sources provide governments additional foreign exchange and allow more imports or repayment of foreign loans. Since distortions in exchange rates result mainly from higher rates of inflation in a country than are experienced by its major trading partners, it is necessary to understand how foreign aid affects inflation in an aided country.

Like cancer, inflation has numerous causes that are not all well understood. In the short run, increases in foreign aid (or availability of additional foreign exchange in general) retard price increases as more imports are purchased with aid money. This effect dissipates, however,, as imported goods are con-

sumed or used in production. After this initial impact, the pac of inflation is determined by economic growth and governmen fiscal, monetary, financial market, wage, and investment po icies. Large government deficits, rapid increases in money sup ply, lax tax collection, tepid domestic savings mobilization, in efficient public investments, rapid increases in the numbe and wages of public employees, repression of financial mar kets, and policies that discourage production are common an they fuel inflation.

In too many cases, large amounts of foreign assistance re inforce policies that promote inflation. Governments view add tional foreign exchange availability, including aid, as perma nent rather than transitory and with it often go on spendin binges, Costa Rica being a recent example (Cespedes an others). Inflation and overvalued exchange rates can easil become more pronounced in countries receiving large amount of aid, much to the detriment of agriculture. AID often follow the lead of the International Monetary Fund (IMF) or th World Bank on exchange rate policies; AID's funding may b conditioned on a country meeting IMF targets. While coord nation of donor effort is desirable, it is unlikely that agricu tural problems will be systematically addressed by IMF's shor run adjustment strategies.

Food Pricing. Low income countries often restrain food pric increases to appease those close to government: labor union government workers, military, and urban consumers (e.g Larson, Larson and Vogel). Egypt is a recent extreme exampl of this policy (Scobie), but the practice dates back to at leas Roman times (Smith, 150). Some governments restrain price through direct controls and use food imports to maintain thes policies. An overvalued exchange rate is often a major facto in this. A donor supplying food on concessionary terms play a widely ignored role in depressing food prices. While U.S P.L. 480 is the most prominent concessionary food sales effor similar cheap food exports from Western Europe are becomin important.

P.L. 480 shipments to Central America have risen substan tially the past several years (Table 3). With current depresse U.S. farm incomes, it is likely there will be strong pressures t make additional U.S. food shipments a significant part of an expanded aid program there. Even though some of this food aid might go to school lunch and food-for-work programs that result in increased demand for food, much of it will compete with internally produced goods. Even with careful efforts by donors and governments, P.L. 480 imports will exert downward pressure on internal prices for a number of commodities. While this eases inflation pressures in the short run, it also undermines the ability of the importing country to feed itself in the long run.

Since produce prices along with yields are the most important factors determining farmers' incomes, the effects of additional P.L. 480 imports on farmers in Central America will be powerful and negative. All producers of commodities whose prices are depressed by these imports will be adversely affected, and few of them will be even partially compensated by receiving a donor largesse. Former milk producers in Bolivia, grain producers in Egypt, and wheat farmers in Colombia are mute testimonies to the insidious effects that large amounts of food imports have on the incomes of local producers. It is tragic that programs to support the incomes of relatively wealthy and well organized farmers in the highest income countries should have their most adverse effects on poor farmers in the lowest income countries.

P.L. 480 legislation requires importing countries to adopt policies that promote agricultural development, but the spirit of this requirement is often honored in its breach. It is common for the U.S. to give food aid to a country first, and then halfheartedly study its impacts later. Seldom does AID negotiate touchy policy issues such as exchange rates and food pricing policies in food aid agreements. Rather, policy issues are finessed by assuming that earmarking some of the local currency generated by P.L. 480 imports for agricultural projects, sometimes snidely called the President Wife's projects, offsets policy problems. Further, it is never clear if these "PL 480 funded" projects are additional to what the government would have done without P.L. 480. If the projects are important, the government always has the option of printing more currency to fund local costs. If the project is one that would have been funded without P.L. 480, the government can easily interchange activities so that AID "forces" expenditures for an

TABLE 3. Value of P.L. 480 Exports to Central America, 1975-84*

Country	1974-75**	1975-76	1976-77	1977-78	1978-79	1979-80	1980-81	1981-82	1982-83	1983-84
					(million U.S.$)					
Belize	.1	-	-	-	-	-	-	-	-	-
Costa Rica	.9	.8	3.8	.7	Nil	.3	.6	7.8	25.4	20.0
El Salvador	1.4	2.4	2.4	1.6	2.5	5.2	18.8	28.2	48.1	36.9
Guatemala	3.4	10.6	4.5	4.3	5.3	3.1	7.3	4.0	5.1	11.3
Honduras	8.7	3.1	2.7	2.3	4.3	3.4	9.4	7.7	14.4	13.2
Panama	.9	1.0	1.9	1.3	1.0	1.0	1.6	1.1	1.2	1.2
Total	$15.4	$17.9	$15.3	$10.2	$13.0	$13.0	$37.7	$48.8	$94.2	$82.6
Nicaragua	1.3	.7	.3	-	3.7	17.6	2.5	.5	-	-

Source: U.S. Department of Agriculture, *Food For Peace: Annual Report on Public Law 480*, various years, and unpublished date on file in the U.S. Department of Agriculture, Washington, D.C.

* Includes exports under the Mutual Security (AID) programs.
** U.S. Fiscal Years.

agricultural project, while the government spends the released funds on projects the donor will not fund.

Fungibility and substitution are impossible to control in these cases, and one never knows if significant additionality has occurred. Because of ample possibilities for exercising fungibility, I would be surprised if AID can use local currencies from P.L. 480 to realize much policy leverage. Hardly ever is it in the interest of Americans who strongly support food aid, especially agricultural attaches and U.S. Ambassadors, to insist on local policy changes. My impression is that too often policy issues discussed in P.L. 480 documentation are window dressing to meet Congressional requirements.

While the extent to which farm prices are depressed by concessionary food imports depends on various factors, including the relative size of imports, their effect is always negative on local farmers. These imports make it easier for governments to sustain food price controls, food subsidies, and to use resources to support cheap food programs at the expense of public investments in agriculture. Lower farm incomes, less capital formation in rural areas, fewer rural savings, less technological innovation in farming, increased food consumption, less purchasing power in rural areas for urban produced goods, and accelerated rural-to-urban migration result from these imports. Combined with overvalued exchange rates, these cheap food imports often subject local farmers to double whammies.

Agricultural Credit. Over the past several decades, expansion and manipulation of agricultural credit have been prominent development tools. AID, the Inter-American Development Bank and the World Bank each have lent billions of dollars to low income countries for agricultural credit. In addition, donors have aggressively encouraged governments to use local currencies for agricultural loans. Following this tradition, the Bipartisan Commission gave top billing to major increases in agricultural credit (pages 49, 57, 59).

To the casual observer funding more agricultural loans is innocuous: since rural people are assumed to be poor, what could be better than giving them claims on additional resources through loans? Further, it is widely assumed that rural financial markets are badly flawed, need resculpturing by

social engineers, and that it is small loss if a formal financial intermediary is ravaged by aid programs: a new institution can be easily erected to replace it (Von Pischke and others). Governments find credit programs are particularly attractive because they can be easily started. In numerous countries, credit programs dominate agricultural development strategies.

Despite mounting criticism, credit projects continue to receive donor emphasis. Criticism centers on the gap between what policy makers hope to accomplish with these projects, and what actually occurs (Adams and others). Typically, donors intrude into rural financial markets by promoting a supervised credit program, an area development program with heavy doses of credit, by providing concessionary funds through rediscount facilities, or by helping to create a new agricultural bank. This usually includes targeting loans to specific groups or activities, concessionary interest rates between several layers of the financial system, and numerous reports and directives aimed at forcing desired lending.

Criticism of these programs centers on how they affect income distribution, how resource allocation is influenced, how savings mobilization efforts are affected, and how the vitality of the financial system is influenced. It has been shown that most cheap credit goes to the well-to-do, and that it helps to sustain fragmented financial markets that inefficiently reallocate claims on resources in an economy. Further, cheap credit policies combined with concessionary rediscount facilities weaken the resolve of financial intermediaries to provide attractive savings opportunities in rural areas, and commonly undermine the integrity of these intermediaries and makes them vulnerable to political intrusions (Adams and others). The net result of this is that rural financial markets continue to serve only a small portion of the rural population, transaction costs for both lender and borrower in rural areas are high, and financial institutions tend to be flaccid, bureaucratic, and slow to innovate. While international donors have had large presence in many rural financial markets, there are few cases where donors have "bought" significant and useful changes in rural financial market policies in Latin America.

Why are donors so ineffective in encouraging financial market reforms? In part this is due to confusion over financial market problems. While most donors recognize that farmers are rational decision makers, they assume that financial intermediaries are robots that can be programmed to do policy makers' biddings. Even more importantly, donors, particularly the World Bank and the Inter-American Development Bank, persist in funding large agricultural credit projects because they are easy ways of moving large amounts of money into countries that have relatively little absorptive capacity. Donor employees may blur and slide over the damage that these programs do to the development of receiving countries because their jobs would be much more difficult to program aid elsewhere.

Without major credit policy changes, the outcome of increases in agricultural loans in Central America will be negative. The bulk of this money will likely move to intermediaries and the utimate borrowers at concessionary rates. Lenders will have powerful incentives to concentrate these cheap loans in the hands of fewer borrowers, and to discourage other potential borrowers by increasing the number of hurdles they face to get loans. The availability of cheap funds from donors or from Central Banks will also discourage lenders from mobilizing voluntary financial savings, and donors will attempt to target loans. Politics will be heavily involved in loan allocation, and loan recovery problems will worsen. Because the track record of the donors in getting policy reforms in financial markets in the past has been so poor, it will be surprising if it improves significantly in the near future.

Savings Mobilization. Surprisingly little attention has been recently given by donors and governments to internal savings mobilization. One currently hears too little about improving the savings mobilization performance of a country as a condition for assistance. Most governments *decrease* their savings propensities when transitory surges of foreign exchange come their way from foreign aid, foreign commercial loans, or from price increases in primary export commodities (e.g. Mexico, Costa Rica and Venezuela). These temporary surges in foreign exchange earnings ought to be seen as an opportunity for a country to increase its rate of savings in order to weather shortfalls in foreign exchange that normally follow these surges.

This lack of savings mobilization is particularly critical in rural areas. The low product prices caused by overvalued exchange rates, plus the direct controls on food prices reinforced by food imports, lessen the ability of the rural households and firms to save. Other policies limit the opportunities and incentives that rural people have to save. This is particularly true of those surpluses that a financial market might assemble in rural areas. It is impossible to induce financial intermediaries, be they agricultural banks, credit unions, supervised credit programs, or cooperatives providing loans, to be interested in mobilizing voluntary financial savings when they receive cheaper funds from the central bank donors. Government bank employees see savings mobilization as more work for the same pay. Furthermore, it is easier to entertain central bank or donor employees to get funds than it is to do the grubby work of assembling voluntary savings from rural people.

Donor programs, by acquiescing to cheap credit policies and concessionary rediscount lines, help a government to ignore savings mobilization. While donors may extract some token increases in interest rates or some moderation of the rates charged on rediscount lines, the weight of large amounts of external funds jammed into rural financial markets is clearly on keeping rates low and supporting a paternalistic financial system.

Policy Leverage. Policy leverage or conditionality is commonly, but quietly, used to justify large doses of foreign assistance (Hirschman and Bird). It is argued that donors are better able to force or lever aided governments to adopt policies conducive to development when large amounts of money or commodities are involved. This assumes, of course, that the donor has identified the correct development policy. In all too many cases, however, leverage turns out to be a figment of the donor's imagination, more apparent than real, or a delusion of grandeur.

Leverage is slippery and illusive, little has been written about it by insiders, and very little evaluation has been done on it (AID). Understandably, governments are loath to admit they have been levered, and it is not cricket for donors to openly boast about leverage prowess. Also, employees tend to exaggerate their claims of leverage accomplishments within donor agencies to enhance promotion possibilities. At the same time, local government officials belittle any leverage to protect bruised egos. Levering occurs behind closed doors and major policy concessions by governments are often buried in classified loan or grant agreements (Tendler).

Unfortunately, the secrecy that surrounds leverage adds a sense of concreteness and accomplishment that is often much larger than real life. Only under extreme circumstances can a donor, even with large amounts of money, nudge a government far from its predetermined policy path, or help to shape policy where virtually none existed. It is much more common to write loan or grant conditions that reflect what the government would have done with or without assistance. In some cases, progressive individuals within a government use the donor as an excuse for making desired policy changes. In still other cases, the government agrees to make tough policy adjustments knowing there will be little penalty if it later reneges. Usually, donor employees are under more pressure to move funds than is the government to obtain them. This is particularly true when large amounts of money are involved and donors have small staffs.

Donors are prone to go through the motions of pushing for policy reforms or to cave in on policy issues after agreements are signed when large amounts of money, or when broader U.S. strategic goals are involved. This is especially true when political commitments have been made by Presidents or Secretaries of State to help a country with pre-stated amounts of money. When this is done the donor employees are under the gun to move money. Because of the large amounts of paperwork required in foreign assistance, it is tempting for donor employees to soft-pedal policy negotiations and to acquiesce when the government does not fulfill assistance agreements. No one enjoys doing the double paperwork of reprogramming assistance because of non-compliance and deobligation of aid agreements.

Donors have other limitations when it comes to stimulating policy changes. While the procedures for preparing aid project proposals are well understood by both donor and receiving government, how to systematically approach policy analysis and adjustments are not. Major economic policies exist for powerful reasons, and special interest groups benefiting from these policies are quick to resist changes. While AID and other donors have capable project preparers and managers, they have only recently begun to add to their very slim policy analysis staffs. They continue to have very few employees who understand both agriculture and macro economics. Short-term consultants can help donors and governments diagnose some policy problems, but they are not able to design and conduct sensitive and timely policy adjustment dialogue.

Because donors have a weak record of affecting policy changes, I am pessimistic about AID's ability in Central America to do any better in encouraging policy adjustments in the future than it has in the past. Their record may even be worse because of their small staffs, the large amounts of money involved, and the political commitments that have already been made. Bad policies are much more likely to be reinforced by more aid than they are to be changed, especially in agriculture.

Conclusions. The issues covered in this article are illusive, subtle, and slippery. I readily admit that observers with integrity may judge the impact of foreign aid on economic policies in more favorable light than have I. Evaluating aid resembles four blind men reporting on their encounters with the chimera of Greek legend: The one scorched by its torch-like breath would conclude it was a dragon; the one jolted by its roar would be sure it was a lion; the one unfortunate enough to cross downwind from the beast and whiff its pungent body odor would be equally sure it was a goat; and the one who stumbled over its tail would have no reservations in calling it a snake. Likewise, while not blind, donor employees may honestly feel that the roaring, the fire and smoke, and the huffing and puffing that accompanies current leverage attempts are effective in forcing proper policy adjustments in aided countries. At the same time a skeptic may see leverage largely as razzle dazzle for Congress and one's bosses that creates an adversarial relationship where more mutual respect and trust should reign.

I do not have a recipe that will immediately increase donors' ability to help evolve better economic policies, but I do have several suggestions. Donors currently spend large amounts of time helping governments understand how to prepare projects for donor funding (e.g. the Economic Development Institute of the World Bank); similar systematic efforts must go into policy analysis and education of policy makers In general, critical policies will only be changed when local government technicians and those who are peers of policy makers convince decision makers that adjustments are in the best interest of the government and the country. These changes should be part of a process and not an event. Applied joint research, workshops, and sharing of information can be important parts of doing this convincing, but it takes time. It also requires people who are experienced in working on policy issues and who are not required to justify their existence by the amounts of money or commodities moved. Universities and organizations such as the International Food Policy Research Institute could play a useful role in this policy analysis and dialogue if time horizons were lengthened and attempts at leverage were largely abandoned.

Rapid agricultural development will be vital in allowing the U.S. to reach its objectives in the Caribbean Basin. I am confident that economic policies, not agricultural projects, will largely determine the pace of that development. Peasants, not privates, will ultimately determine the success or failure of U.S. efforts there.

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