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FOOD AID AND DEVELOPMENT OF THE PRIVATE SECTOR

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BACKGROUND: IMPORTANCE AND POTENTIAL OF FOOD AID

There is increasing recognition that food aid has become and continues to be a major component of most Missions' assistance portfolios. For the past three fiscal years, PL480 excluding emergency food aid has accounted for 20-30% of total U.S. economic assistance to Africa. When initial local currency receipts and subsequent reflows are added, the total fraction of Mission resources attributable to food aid becomes substantially higher. For a number of Missions, food aid and related local currency resources account for over half their discretionary budget.

The current drought in the U.S. highlightS the difficulties of projecting year-to-year PL480 assistance levels. Nevertheless, at a time of severely constrained development assistance budgets, the relative importance of food aid and related local currency reserves necessarily will continue.

It also is clear that there is considerable potential for more assertive use of food aid resources to foster self-sustaining increases in income generation in host countries. Such increases can take place in at least three ways:

- Through changes in the actual physical supply and distribution of PL480 food and related commodities;

- Through use of the leverage provided by food aid to encourage changes in the host country government policy framework; and

- Through use of local currency reserves to implement project measures to promote agricultural development or general private sector development.

After briefly characterizing the types of needs generally encountered in most countries in sub-Saharan Africa, this paper addresses each of the above three areas of potential intervention. It then suggests how Missions can more effectively integrate food aid into their overall private sector development strategies and programs.

GENERAL NEEDS FOR CHANGE

The types of changes typically needed presumably are well known to Missions and to AID/W. Certainly AID devotes considerable resources -- to CDSS analyses, agricultural policy studies and assistance, private sector strategy studies, and so forth -- to understanding and addressing host country problems.

One conclusion from such studies is that, while there are real differences among countries, the most pressing problems are encountered generally, albeit to varying degrees, in most countries in Africa. In agriculture, for example, typical problem areas include:

- Unrealistically low exchange rates, which on the one hand necessitate detailed government administrative controls over imports and on the other hand reduce returns to export-oriented farmers and processors;

- Government-controlled domestic prices which provide insufficient incentive for producers;

- Excessive government involvement in marketing and distribution of both agricultural inputs (including credit) and outputs, with attendant high costs, input shortages, and other adverse effects;

- Political allocation of credit and other inputs and outputs (including food aid itself) which by definition are "scarce" since prices are below the market-clearing prices which would balance supply and demand);

- An overall food system which -- due to insufficient production even in good years, lack of storage, most people's inability to purchase food, etc. -- has an inherent risk of widespread famine at regular intervals, if not permanently; and

- Long-term deterioration of the soil, water and other natural resources and the roads and other man-made infrastructure on which agriculture production and distribution must depend.

Similar types of problems can be enumerated for the private sector generally:

- The "modern" sector typically is small, primarily because purchasing power is both limited and highly concentrated. In many cases, the sector or component subsectors are dominated by one or a very few firms, some or all of whom could not compete economically were it not for tariff protection, price controls, or other government market intervention. Managerial skills are scarce, entrepeneurial skills tend to be concentrated in trading or other short-term activities, and in many countries management and entrepeneurship are dominated by unpopular ethnic groups or foreign firms. Government attitudes ranging from benign neglect to outright hostility are reflected in restrictive regulations, parastatal monopolies and other obstacles to private sector development.

- o Financial and capital markets generally are undeveloped. Except for housing finance, in most countries there is little financial intermediation outside the commercial banks. Most of the large banks are government-owned or are controlled by foreign banks that typically set country exposure limits, lending policies, etc. from London or Paris. Few banks have branches outside the largest urban centers. An inordinate share of financial resources are channelled to the government and parastatals, consequently limiting capital for productive private enterprise. With few exceptions, there are few or no institutional sources of equity capital or loans for small or startup companies; and there are no financial instruments or other mechanisms, such as rediscount facilities, by which financial intermediaries can spread risk.

- o The informal/microenterprise sector, with few or no institutional sources of credit or technical services, relies very largely on extended-family and other informal sources which rarely are well understood. In many countries, government licensing requirements, other restrictions on operations (e.g., movement of commodities), policies regarding urban squatter settlement, etc. actively hamper the informal sector. Although there are some examples of excellent PVO work, there have yet to be successful interventions in Africa on anything approaching the scale of microenterprise development programs in Asia or Latin America.

This description is not meant to be complete. Also, in many countries positive changes are being introduced or seriously contemplated. Nevertheless, the above general characterization provides a useful context within which to consider the potential for using food aid to foster self-sustaining increases in income and employment generation in Africa.

POTENTIAL USES OF FOOD AID TO FOSTER ECONOMIC CHANGE

AID still is in the process of institutionalizing private enterprise development as an approach to general economic development. Most Missions have progressed beyond the initial reaction of designing specific private enterprise projects and now are working to integrate private sector approaches into overall country development strategies. In devising such strategic approaches, PL480 and related local currency reserves may provide some of the Mission's most flexible and effective resources.

1. Supply and Distribution of PL480 Assistance

The first area in which PL480 can be useful in fostering self-sustaining economic development is in the physical supply and distribution of food aid itself.

A first step is to assure that such food aid has no inordinate negative impacts, as experience has shown that it can. For example, in a Caribbean country, recent large-scale PL480 importation of sorghum undercut local markets for sorghum being developed by private producers trying to diversify (with AID encouragement) out of sugar.

In African countries where government controls keep grain prices below market-clearing levels and most of the population has little ability to acquire food for cash, there probably is less danger of food aid creating serious local market disincentives. Nevertheless, where large quantities of maize or other grains move through a few regional market towns, there will be an impact.

More positively, AID can use PL480 negotiations to push for liberalized pricing and distribution in those sectors where commodities are to be imported. At a minimum, the U.S. can negotiate terms to assure that its own food aid not be monopolized by parastatals. This approach has been used successfully by Missions in the CIP program -- for example, in promoting private sector imports blending and distribution/marketing of imported fertilizer in Kenya -- as well as the PL480 program. Also, AID can press for specific changes in regulations which adversely affect private trade -- for example, regulations precluding private sector bulk commodity movement between regions or price/margin controls that effectively preclude efficient private sector processing and distribution. These and other changes can be presented as necessary for the efficient distribution of the PL480 commodity itself.

The objective of these negotiations is not to increase the private sector's role *per se* but rather to improve the functioning of markets. Since the essence of efficient markets is choice -- for both suppliers and consumers -- the primary objective is to promote effective competition. In this context, where a private firm has a monopoly position in processing or distribution, this may be as much a cause of excessive distribution margins and poor service as would a similar parastatal monopoly. In such cases, AID negotiations should promote increased competition however that best is achieved.

Where food is distributed through PVOs, their programs similarly can be designed to encourage a long-term increase in competition in marketing and distribution, as well as to help build up a private sector which will function long after the PVO's direct involvement has ceased. PVOs also can play a valuable monitoring role in distribution sectors with which they are familiar.

Finally, where undervalued exchange rates or internal price controls result in internal prices which are below market-clearing levels, the U.S. may negotiate changes which result in pricing of its food imports at or near market prices. The most direct approach, where there are many prospective buyers, is to negotiate use of a commercial auction or other "free-market" means of setting prices. An example of a less direct approach is the recent sale of vegetable oil in Uganda at a negotiated price which at least partially offset the serious overvaluation of the shilling.

2. Negotiation of Government Policy Changes

As is the case with other AID assistance programs, Missions can use the leverage provided by food aid to promote favorable changes in the host government's policy framework. Historically, the U.S. has used the leverage afforded by PL480 to push for changes within the agricultural sector itself.

There are numerous examples of recent agricultural policy changes in Africa brought about at least in part because of AID initiative (not necessarily in conjunction with PL480). A number of countries including Madagascar, Cameroon, and Somalia have liberalized some agricultural markets. Malawi has undertaken reform of the Agricultural Development Marketing Corporation. Mali's market liberalization, prompted and supported in part by U.S. food aid, has increased private sector participation. In Zambia, Sudan, Liberia, Niger and other countries AID is both providing long-term agricultural policy assistance and trying to use food aid and other resources to accelerate government agricultural reforms. Such reforms ideally will include market-based pricing of both agricultural products and inputs (including credit), private sector participation on an equal if not preferred footing in marketing and distribution of agricultural products and agricultural inputs, improved market and price statistics, and strengthening of linkages between farms and market centers.

Use of PL480 leverage need not be restricted to agriculture. For example, a number of Missions, recognizing the potential of more effectively mobilizing domestic capital resources, are involved in promoting financial market reform. Two examples in North Africa are Tunisia and Morocco. A major focus of attention in both countries is liberalization of financial and capital markets. Measures under consideration in one or both countries include liberalization of reserve requirements and interest rate and lending ceilings, strengthening of equity markets, establishment of a legal framework for debt-equity conversions, and financial/capital market initiatives to broaden local private sector capitalization of possible parastatal divestitures. There also is a recognition that broader domestic capital mobilization will require stricter accounting standards, insurance or other protection for small bank depositors, satisfactory legal protection of the rights of minority investors, supervision of stock exchange practices, and similar steps to increase confidence in the financial system. Missions in both countries are considering the role of PL480 leverage and local currency to promote such changes.

Worldwide, AID policy-related financial and capital market initiatives, which could be part of PL480 negotiations, span a broad spectrum including:

- Domestic financial market liberalization (Bolivia, Ecuador, most CBI countries)
- Tax, regulatory and other reforms to promote domestic or foreign private sector investment (CBI countries, Kenya, Mauritius, Senegal, Egypt, Indonesia)
- Tariff reforms and/or exchange rate liberalization (Kenya, Zambia, Guatemala, Ecuador)
- Price policy changes (many countries including, in Africa, Ghana, Guinea, Zambia, Morocco, Tunisia)
- Divestiture of state-owned enterprises or market liberalization to diminish parastatals' monopoly position (Senegal, Guinea, Sudan, Togo, Zaire, Sierra Leone, Mali, Kenya, and many countries outside Africa)

3. Use of PL480 Local Currency

Passage of Section 108 of the Food Security Act of 1985 and the expansion of Title II monetization have focused attention on the use of PL480-generated local currency to stimulate private sector development in host countries.

In fact, where relations with host governments have permitted, AID long has used PL480 local currency under Section 106, as well as other local currency resources, to fund studies, technical assistance, or specific projects. Such resources have been used extensively for agricultural credit, for example. Local currency also has been used extensively to provide financing, technical assistance and market development for a broad spectrum of small and medium-scale enterprises including agricultural and other cooperatives (including women's cooperatives), small and medium-scale formal sector businesses and informal sector microenterprise. Local currency resources also have been used to finance artisan training, workshops, planting of tree crops, labor-intensive urban squatter settlement infrastructure such as simple sewerage, market town development, and other infrastructure which indirectly supports small-scale enterprise development.

Section 108

Section 108 programs now are in place in Morocco, Tunisia, Dominican Republic, Costa Rica, Jamaica and Sri Lanka and are under development in other countries. The focus of most programs so far is on provision of straightforward secured medium-term lending to medium-scale private enterprises both within and outside the agribusiness sector. Most, though not all, use well-established commercial banks as intermediate financial institutions (IFIs), reflecting the finding in most countries that there is a shortage of medium-term capital. Also, Missions desire a vehicle which could absorb potentially large financial flows with relatively low levels of risk of default. In some cases, Missions also want to push commercial banks to redirect a portion of their own lending resources in desirable directions (more medium-term lending, more lending in rural areas or to smaller enterprises, etc.).

While so far concentrating on commercial bank relending, Missions have considered a broad range of Section 108 options. In some cases, particularly in the CBI region, Missions in fact have provided local currency financing for many of these initiatives using ESF resources. A number of these options much more explicitly support domestic financial/capital market development in addition to directly providing financing for private sector enterprises. Options considered or actually implemented include:

- Establishment of a rediscount facility for medium-term loans or paper (Dominican Republic, Costa Rica)
- Preferential interest rates for U.S.-domestic agri-business joint ventures (Morocco)
- Section 108 loans for equipment leasing (Sri Lanka)
- Section 108 loans to bank-owned venture capital companies, with the parent bank providing guarantees of such loans (Morocco)
- Promotion of new agricultural or forest product markets (Jamaica and, outside section 108, other CBI countries, Philippines and Indonesia)
- Co-financing of private merchant banks, development banks or venture capital companies (CBI countries, Thailand, Sri Lanka, Indonesia, Philippines, Kenya)
- Establishment of rural small enterprise lending or investment facilities (Bangladesh)
- Financial support of financial market broker-dealers (Morocco)
- Section 108 lending for domestic private purchase of shares in enterprises divested by parastatals (Morocco)

Credit or equity investment, of course, is only part of what is required for effective enterprise development, particularly where an important AID objective is to broaden social participation in such development. In the Kenya Equity Capital project which IRG is carrying out with Equator Bank, for example, training and technical assistance are at least as important as the financial resources provided. Fostering rural and small-scale urban enterprise typically requires even broader technical assistance, particularly where -- as for example in the Central Java project -- accelerated enterprise development hinges on development of new markets.

Section 108 authorizes only limited resources for such training or technical assistance. It authorizes some resources for institutional development of PVO-affiliated IFIs; but such resources are limited and so far, except for Jamaica, Missions appear cautious in considering other than traditional commercial institutions as IFI's. It therefore is likely that Section 108 will serve primarily as a means of providing loans alone -- with no accompanying non-financial assistance -- to modern sector enterprises which are large enough, sufficiently well established, and sufficiently urban (i.e., near an IFI branch) to qualify for commercial bank credit.

<u>Other Local Currency</u>

Much of what Missions want to accomplish to promote private sector development would not fit easily within a Section 108 program. Thus, Section 108 may be well-suited for promoting financing of private tractor service contractors, road haulers, expansion of agricultural storage or processing enterprises, or possibly crop diversification by existing large-scale private farmers or cooperatives, and so forth. It would not be as well suited to, for example:

- o Provision of integrated assistance (financing and institutional support) to smaller scale urban or rural enterprises, rural cooperatives, etc.;
- o Provision of farm-level assistance in soil conservation, tree planting, and other programs to arrest degradation of the farmers' natural resource base;
- o Development of marketing infrastructure such as improved rural roads, upgrading of rural market centers, and so forth.
- o Management training for small enterprises; and
- o Risk capital and for new enterprises.

For programs such as the above, Missions could use jointly programmed local currency (e.g. Section 106 or CIP) or Title II monetized food receipts. In both cases, the technical assistance component is likely to require some dollar financing of an implementing PVO or a technical assistance contractor. Thus, Missions probably will have to do some joint programming of local currency and DA dollar resources.

Food for Work

Food for Work programs -- and certainly cash for work programs using monetized food aid receipts -- can be considered as combining both food aid and local currency programming objectives. Without opening up the broader debate about the efficacy of Food for Work programs, one can identify types of activities where such programs could support agricultural or enterprise development objectives without fostering dependency on "giveaway programs". Food (or cash) for work would seem appropriate, for example:

- For projects yielding communal rather than individual benefits (labor-intensive rural roads, tree planting or other soil conservation on upper watersheds or other public lands, sewage or other projects in urban squatter settlements, establishment of local seed banks etc.), all of which improve the infrastructure or resource base for farmers or small enterprises;

- For projects requiring a greater degree of cooperative organization than previously existed, even where benefits are individual (e.g., hand-dug irrigation canals or establishment of new produce marketing or craft cooperatives)

- Where benefits may not be sufficiently recognized to elicit individual effort (e.g. shelterbelts)

- As initial "seed capital" for what could become local revolving funds (with farmers, microenterprises, or small cooperatives paying back into the fund a portion of the resources created by the initial food-supported work).

There may be other advantages of food for work as well. Such programs may provide a vehicle for delivering nutritional and primary health care information and for introducing nutritionally advanced products not previously available locally. For example, the Kenya Equity Fund currently is assessing use of food for work programs to introduce a low-cost locally produced maize-based infant weaning formula which can be stored for months without refrigeration. Programs also may be used in building market linkages. For example, in Bolivia during the period of hyperinflation, AID used local currency resources to implement a totally produce-based rural lending program, with farmers receiving a "loan" of seed potatoes and "repaying" commercial potatoes into the loan fund. Once communities started receiving large quantities of potato payments they were forced to consider improved marketing and distribution options, which then were applied to farmers' output generally.

Three findings from IRG's assessments of food for work programs are important. First, as with other farmer or village-level assistance programs, local participation in project conception and execution is an important determinant of project success. The top-down way in which many food aid programs are administered, together with pressures to move food aid quickly and in large volumes, often makes it difficult to achieve such participation. Second, such programs have intensive requirements for expertise in local facilitation, project conception/design, and technical aspects of forestry, soil conservation, crafts marketing and so forth. With the exception of CARE and a few others, most PVOs will require years of carefully programmed institutional support to build the necessary design and technical support infrastructure. This will require a long-term dollar financing commitment from AID. Third, we concluded, and a number of PVOs concurred, that improvement in project conceptualization and design capabilities is generally even more important than upgrading of technical/operational skills and knowledge -- yet AID support more often is directed to building technical rather than design capability.

Constraints

Missions of course face limitations in their ability to program and manage large amounts of local currency. Section 108 mandates that Missions use IFIs rather than micromanage their own local currency lending programs. Even within this framework, however, a Mission may be able to support a simple commercial bank medium-term loan program but may have inadequate personnel resources and background to, for example, help NGOs develop new small enterprise loan programs or support dramatic expansion of credit unions or rural cooperative finance societies. This implies that, particularly for small enterprise programs, Missions are likely to have to delegate more authority, and leave commercial IFIs or PVOs more flexibility, in project design and execution.

Also, it is well to keep in mind that AID is advocating market based strategies in countries where most people's market participation is quite limited. Most people's participation on the supply side is limited to selling agricultural products, possibly fuelwood or charcoal, urban informal sector goods or services, or perhaps their occasional labor. Urban dwellers may consume food products, fuelwood or charcoal, housing (generally in illegal settlements), and perhaps a few simple informal sector housewares or other goods. Farmers or rural dwellers may purchase a few agricultural or other inputs. Given this limited market participation, AID needs to coordinate macro-level market approaches with other complementary programs to reach target groups directly. Local currency projects through PVOs or others are likely to be important components of such complementary targeted programs.

SUGGESTIONS FOR MORE EFFECTIVE USE OF FOOD AID RESOURCES

Based on the above comments, we offer suggestions for making more effective use of food aid resources.

First, much more explicitly integrate food aid into overall Mission planning and strategy development and policy-related technical assistance. Use of food aid resources should be addressed in developing and implementing Mission approaches to and projects in agricultural policy, financial market development, and private sector development. A central premise of U.S. policy in Africa is that market liberalization and diminished government operational involvement are necessary ingredients of economic rehabilitation. Closer integration of food aid into overall Mission strategy development therefore means more assertive use of food aid and related local currency to promote such liberalization.

Second, recognize that PL480 local currency will account for only a small fraction of total financial resources. Therefore, Missions will have a real impact only if they succeed in leveraging their own resources, whether through changes in the government policy framework, attraction of complementary private sector lending or investment, financial market improvements, investment in improvement in managerial or entrepreneurial skills, or other means. Such leveraging should be an explicit Mission objective.

The domestic financial sector should be one of the primary vehicles for leveraging AID local currency resources. To the extent that AID can promote more effective mobilization of domestic capital and direction of such capital to those uses providing the greatest economic and social return, Missions are likely to achieve substantially greater leveraging than they possibly could through direct financing of individual enterprises.

Third, provide a more effective vehicle to enable Missions to learn both from the current experience of other Missions and from the extensive base of past experience with PL480 and non-PL480 local currency use. For example, what can be learned from current and past large-scale food aid programs on the Indian subcontinent and in Southeast Asia, an important aspect of which has been to introduce new agricultural strategies which in some respects bear marked resemblance to those currently envisioned in Africa? What can be learned from ESF local currency lending in the CBI region, which amounted to over $100 million in each of many countries and which has had as explicit objectives agribusiness development, financial/capital market development, and general private sector development? What can be taken from the very different models of microenterprise development which have evolved in South Asia and South America?

Fourth, both provide more flexibility and authority to field implementing institutions and allocate the design and technical support resources necessary to use such flexibility and authority effectively. Such allocations should include a long-term commitment to provide the dollar funding necessary to build institutional capability to support field private sector development. The amount of such funding requirement will vary with the nature of the implementing institution (for example, it is likely to be greater for a PVO than for a well-established commercial IFI).

Finally, and related to the two preceding points, Missions could take much greater advantage of available AID/W technical resources. Contractors on such central projects as Private Enterprise Development Support, Financial Markets Technical Assistance, Privatization, Agricultural Policy Analysis, and Rural and Regional Income Generation have a very useful base of experience and insight. They also are well positioned to help Missions be aware of and learn from experience elsewhere. Similarly, they or other contractors could usefully be paired with PVOs or other implementing institutions.

Despite the existence of these AID/W resources, they are not necessarily easily identifiable, accessible, or supervised by field Missions. A core group within the Africa Bureau that could draw together assessments of present and past experience, conceptualize and test approaches, and access specialized experts from PEDS, Financial Markets Assistance, Rural and Regional Income Generation and other sources would provide a valuable service to assist Missions in taking maximum advantage of food aid as part of their overall development assistance strategies. Such a group also would be well placed to evaluate Mission experience on an ongoing basis in order to enable the Africa Bureau continually to improve its approaches to uses of food aid to stimulate development.