Second Draft
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Discussion Paper on Cash Transfers

I. Introduction

Over the last several years cash transfers (CTs) have been an important vehicle for delivering U.S. assistance from the Economic Support Fund (ESF). From an already substantial level, CTs increased sharply in FY 1985 and continue at a high level in FY 1986. Along with the enhanced role of CTs has come increased criticism from Congress and the public, sparked in part by a perception that this kind of aid can associate the United States with host country corruption and capital flight. Another strand of criticism is that CTs fail to promote U.S. exports.

The objective of this paper is to contribute to a better understanding of the nature and role of CTs and to thinking about how best to manage this component of U.S. economic assistance programs. The paper reviews the rationale for and facts about CTs, analyzes the strengths and weaknesses of CTs compared to commodity import programs as a means of providing balance of payments assistance, and assesses procedures for monitoring/ controlling the use of cash transfer dollars.

In summary, the paper concludes that CTs are an efficient vehicle for delivering balance of payments assistance. In order to mitigate their disadvantages and to respond to the criticisms noted above, it is suggested that consideration be given to strengthening controls over CT dollars by extending the use of agreements to match them with imports from the United States or other eligible sources, or by requiring the establishment of special accounts. For the latter, however, new legislation would be needed.

II. Rationale for Balance of Payments Assistance

Development assistance is used primarily to fund projects designed to support growth and alleviate the causes of poverty.

But development assistance is part of the wider U.S. program of economic assistance which has political, strategic, humanitarian and other economic justifications as well as the developmental objective.

In the past, a variety of circumstances have induced the United States Government to provide quick disbursing economic assistance to particular countries for political and strategic reasons. Justifications for such assistance have included, but have not been limited to, furthering the Middle East peace process, assuring U.S. access to military bases and facilities, supporting the Caribbean Basin Initiative, and attempting to make constructive engagement effective in southern Africa. Although the Department of State takes the lead in determining allocations based on political and strategic considerations, A.I.D. administers the delivery of that assistance. Within the discretionary scope available to it, and encouraged by Congressional mandate, A.I.D. has attempted to direct economic assistance, including Economic Support Funds, toward basic human needs and development goals.

Political objectives aside, U.S. economic assistance agencies have always sought to direct their resources into uses that would make the maximum possible contribution to the well-being of the people in each recipient country. Since the end of the Marshall Plan and until recently, this effort has directed most development assistance into support for projects. Every developing nation possesses a range of potential projects, already on the shelf or that can be developed with appropriate preparation; only fiscal, foreign exchange, or some other constraint prevents their execution. Often, development assistance can release the binding constraint to faster growth, usually foreign exchange availability, by financing the offshore costs of the inputs and technical assistance needed to implement particular projects. Project appraisal is one of the best developed techniques of economic assistance agencies. A.I.D. missions devote a major part of their staff resources to identifying, developing, and implementing sound projects.

Projects usually take years to implement. They are consequently not generally effective in meeting the immediate economic needs of a recipient government. For this reason especially, quick disbursing balance of payments (BOP) assistance may provide more political and policy leverage than can an equal amount of project assistance.

In the absence of compelling political justifications, economic circumstances alone may argue for the provision of BOP assistance. With it, A.I.D. supplies finance the recipient nation can use to provide maintenance and repairs for existing factories and infrastructure and to obtain inputs used in current production. Ordinarily, only a fraction of this kind of financing is used to import or to produce capital goods, the main product of many projects.

One set of economic circumstances justifying BOP assistance arises when a nation's foreign exchange resources are insufficient to provide imports needed to maintain the integrity of existing capital or to operate it at full capacity. In these circumstances the nation's labor force and other resources are underused, and its capital stock deteriorates. The prospective returns to projects that would increase the nation's physical and human capital stocks are therefore reduced. In such cases, BOP assistance that provides replacement parts, maintenance materials, and inputs can contribute more to national welfare, including development, than can any project. The current heavy burden of debt service in many developing nations has made this set of economic circumstances increasingly likely to appear.

The second set of economic circumstances justifying BOP assistance involves the existence of inappropriate economic policies that such assistance can help to reform. Inappropriate economic policies reduce the likely return to prospective projects, and they reduce the general efficiency with which the host nation's own resources are used. Because economic policy reforms often involve losses to vested interests, immediate costs to government, and significant delays before producing benefits, BOP assistance can sometimes provide the critical margin that will induce a government to undertake reforms. Where A.I.D. staff is convinced that particular reforms will contribute to the host nation's welfare while the nation's government is reluctant to change, BOP assistance is much more easily tranched, conditioned on specific reforms, and held back pending reforms than is project assistance.

Because the recipient government has greater latitude in the use of BOP assistance than it would have with projectized resources, BOP assistance is, dollar for dollar, more highly valued by the recipient and thus provides A.I.D. with greater leverage in stimulating policy reform. Because BOP assistance tends to concentrate A.I.D. funds in larger units than would any of a series of specific projects, BOP assistance is likely to give A.I.D. officials more effective voice in the host government's economic policy making process.

These two sets of circumstances almost always overlap. Shortages of imported replacement parts, maintenance materials, and inputs are usually accompanied by, indeed, are usually caused by, inappropriate economic policies. Therefore, most BOP assistance can simulantaneously be conditioned on economic policy reforms while the transferred resources repair the capital stock, reduce unemployment, and raise current output. Effective BOP assistance therefore combines the benefits of improved use of existing recipient nation resources with the likely returns to public welfare from additional policy reforms. Where this combination exceeds the likely returns to public welfare from projects, conditioned BOP programs promise the best use of economic assistance.

If a counterpart fund is established and allocated only with agreement by the donor, the host's budget policies also become the object of economic reforms. BOP assistance may therefore yield reform in host government budgeting, reform in other host economic policies, and increases in current output.

Where political or security considerations influence U.S. decisions about uses of economic assistance, the cost/benefit analysis of projects and the less precise estimates of the economic benefits of BOP assistance become elements which, along with political and security concerns, are considered when the decisions are made. In some cases, the economic considerations influence decisions about the delivery of assistance only after political concerns have determined allocations. Where the United States observes political or security benefits already delivered or potentially available from a prospective recipient of economic assistance, the United States may decide to reward past or to pay for future benefits. Economic analysis and development objectives may influence the delivery terms but not the country allocation of such assistance.

In some cases, Congress earmarks economic assistance to particular countries with the expectation that no policy conditions will be applied. In base rights and military access negotiations, the United States Administration may commit itself to "best efforts" to have Congress appropriate particular amounts of assistance which may or may not be projectized and/or associated with conditions on use or on policy reforms.

In most cases, U.S. allocation decisions reflect both political/security and economic considerations. The relative weight of the political and of the economic elements differs from case to case. In extreme cases, the political/security element leads to decisions to provide BOP assistance where the economic rationale is weak but where the recipient governments prefer the greater latitude of use of BOP resources. In retrospect, the surprise may be the extent to which, in such politically charged circumstances, A.I.D. has been able to engineer developmental uses of BOP assistance. Looking forward, the challenge, of course, is to institutionalize means by which A.I.D. can improve the prospects that future politically motivated economic assistance will simultaneously achieve developmental objectives.

III. Basic Facts on Cash Transfers (CT) and Commodity Import Programs (CIP)

A. Trends in Balance of Payments Support.

All A.I.D. Cash Transfers and CIPs are financed from the Economic Support Fund. ESF obligations in the form of CTs and CIPs are defined here as balance of payments support. These have risen rapidly over the last several years. Total obligations in these categories amounted to $1.5 billion in FY 1981, increased to $2.1-$2.2 billion during FY 1982-FY 1984, and then to $4.1 billion in FY 1985. As a proportion of major bilateral economic assistance categories, defined as all A.I.D. and PL 480 programs, ESF CTs and CIPs rose from 27% in 1981 to 41% in FY 1985.

If Title I of PL 480 is defined as balance of payments support as well, total BOP funding jumped from 40% of major bilateral economic assistance in FY 1981 to 50% in FY 1985. These proportions are expected to remain about the same or even to increase slightly in FY 1986. (See Table 1) It is clear, therefore, that in the aggregate balance of payments assistance has become a major feature of U.S. bilateral economic aid programs.

Table 1.
U.S. Bilateral Balance of Payments Assistance
($ millions)

Fiscal Year	(1) Major Economic Asst.(MEA)	(2) ESF NonProject (ESF NP)	(3) ESF NP % of MEA	(4) PL 480 Title I	(5) Title I +ESF NP % MEA
1981	5,751	1,549	27	774	40
1982	6,304	2,086	33	690	44
1983	6,617	2,090	32	773	43
1984	7,020	2,201	31	784	43
1985	10,184	4,144	41	984	50
1986(est)	8,928	3,660	41	986	52

Notes
1. Obligations and Loan Authorizations
2. Major Economic Assistance (bilateral) is the sum of all A.I.D. programs and all PL 480 programs.
3. ESF non-project is the sum of cash transfers and CIPs.

B. ESF Cash Transfers

Cash Transfers amounted to about $1.5-$1.6 billion during FY 1982-FY 1984, but then increased sharply to $3.6 billion in FY 1985. They are estimated at $3.2 billion in FY 1986. Between FY 1982-FY 1984 and FY 1985-FY 1986 CTs increased from just over 50% to nearly 70% of ESF obligations and from about 30% to 45% of all A.I.D. funding. Over FY 1982-FY 1986, 55% of all cash transfers are to Israel, while 82% of all CTs are going to five countries--

Israel, Turkey, Egypt, El Salvador and Costa Rica. However, CTs have been going to a growing number of countries in Africa and LAC. (See Tables 4 & 5)

Table 2.

CTs as a Percentage of Total Bureau ESF Obligations

	FY 84	FY 85	FY 86
AFR	21	42	39
ANE	51	68	69
(of which Israel and Turkey)	(81)	(81)	(78)
LAC	80	85	81
Total ESF % for Cash Transfers	52	69	69

C. Commodity Import Programs

There is no evident trend in the total amount of CIPs during FY 1982-FY 1986, although it may be on the decline. Total CIPs fall within the $400-$600 million range throughout this period, but the highest figure was in FY 1982, while the lowest is the estimate for FY 1986. (See Table 6) Taking the period as a whole, 51% of all CIP funding went to Egypt, while 81% of total CIP funding was for Egypt, Pakistan and Sudan. (Table 7)

In contrast to CTs, as a percent of total bureau ESF obligations CIPs have declined in recent years.

Table 3.

CIPs as a Percent of Bureau ESF Obligations

	FY 84	FY 85	FY 86
AFR	51	37	40
ANE	16	9	8
LAC	0	0	0
Total % of ESF for CIPs	18	9	10

Table 4.
ESF Cash Transfers FY 1982 - FY 1986
($ millions)

			Percent of Total	
			All	All Except Israel
1	Israel	6,349	54.8	
2	Turkey	1,019	8.8	19.5
3	Egypt	812	7.0	15.5
4	El Salvador	719	6.2	13.8
5	Costa Rica	587	5.1	11.2
6	Honduras	340	2.9	6.5
7	Jamaica	331	2.9	6.3
8	Portugal	236	2.0	4.5
9	Dominican Repub.	218	1.9	4.2
10	Liberia	173	1.5	3.3
11	Philippines	165	1.4	3.2
12	Sub-Total:(1-11)	10,949	94.6	88.0
13	Others	627	5.4	12.0
14	Total All Countries	11,576	100.0	
15	Total Excl Israel	5,227		100.0

Note: Listed countries are all those receiving in excess of $88 million during the period. See Table 5 for a complete list.

Table 5.
ESF Cash Transfers
($ millions)

	Fiscal Years					
	1982	1983	1984	1985	1986	Total
ANE						
Israel	806	785	910	1,950	1,898	6,349
Turkey	300	285	139	175	120	1,019
Egypt	-	-	102	350	360	812
Portugal	20	20	40	80	76	236
Philippines	-	-	-	45	120	165
Thailand	5	5	5	8	5	28
Spain	22	12	-	5	-	39
Sub-Total	1,153	1,107	1,196	2,613	2,579	8,648
LAC						
El Salvador	100	120	108	244	147	719
Costa Rica	20	156	130	160	121	587
Honduras	35	56	40	148	61	340
Jamaica	88	54	50	81	58	331
Dominican Republic	41	8	34	95	40	218
Guatemala	-	10	-	-	48	58
Panama	-	-	-	50	6	56
Belize	-	-	-	13	2	15
Ecuador	-	-	-	4	20	24
Bolivia	-	-	-	-	14	14
Uruguay	-	-	-	-	14	14
Nicaragua	5	-	-	-	-	5
Grenada	-	-	-	3	-	3
C.A.Regional	-	-	10	45	-	55
Sub-Total	289	404	372	843	531	2,439
AFR						
Liberia	35	32	35	43	28	173
Sudan	-	20	18	50	-	88
Kenya	11	30	-	-	-	41
Zambia	-	-	-	25	15	40
Senegal	-	-	10	15	11	36
Mali	-	-	-	17	-	17
Malawi	-	-	-	12	-	12
Rwanda	-	-	-	10	-	10
Chad	-	-	3	-	7	10
Niger	-	-	5	-	4	9
Mauritius	-	-	-	5	-	5
AEPRP[a/]	-	-	-	-	48	48
Sub-Total	46	82	71	177	113	489
Total	1,488	1,593	1,639	3,633	3,223	11,576

a/ African Economic Policy Reform Program - not yet allocated to specific countries.

Table 6.
ESF Commodity Import Programs
($ millions)

	Fiscal Years				
	1982	1983	1984	1985	1986
ANE					
Egypt	350	300	301	200	164
Jordan				50	50
Pakistan	60	60	92	107	78
Sub-total	410	360	393	357	292
AFR					
Kenya			21	25	14
Madegascar				3	2
Mauritius	2	2	4	2	2
Mozambique			6	11	10
Niger				5	
Senegal		5			
Seychelles	2	2	2	2	2
Somalia	19	16		27	21
Sudan	100	60	102	61	55
Zaire			10	10	
Zambia	15	15	15	10	
Zimbabwe	50	37	10		10
Sub-total	188	137	170	156	116
Total	598	497	563	513	408

Table 7.
ESF Commodity Import Programs: FY 1982-FY 1986
($ millions)

			% of Total
1.	Egypt	1,315	51.0
2.	Pakistan	397	15.4
3.	Sudan	378	14.7
4.	Zimbabwe	107	4.1
5.	Jordan	100	3.9
6.	Somalia	83	3.2
7.	Kenya	60	2.3
8.	Zambia	55	2.1
9.	Mozambique	27	1.0
10.	Zaire	20	0.8
11.	Mauritius	12	0.5
12.	Seychelles	10	0.4
13.	Madegascar	5	0.2
14.	Niger	5	0.2
15.	Senegal	5	0.2
Total		2,579	100.0
Total excluding Egypt		1,264	49.0

D. Causes of Growth in Cash Transfers

During FY 1982-FY 1984 cash transfers reflected primarily requirements for Israel, base rights and military access countries and a substantial need in LAC resulting partly from security considerations and partly from serious balance of payments problems being experienced by a number of countries where there are major U.S. interests at stake.

In FY 1985 there was a sharp increase in these requirements and in cash transfers to meet them. Such requirements continue into FY 1986, although cash transfers are being reduced somewhat owing primarily to overall budget stringencies. Cash transfers to Israel increased over a billion dollars in FY 1985 and are still double the FY 1984 level in FY 1986. A substantial increase in such funding for Egypt reflects emerging balance of payments difficulties resulting, inter alia, from large debt service payments to the United States. A combination of political and security considerations along with serious balance of payments difficulties also account for the growth in cash transfers to El Salvador, Honduras, and the Philippines. Severe balance of payments difficulties were also being addressed in a number of other LAC countries where the U.S. has major interests.

The increase in cash transfers to Africa in FY 1985 reflects mainly the implementation of the African Economic Policy Reform Program, under which five countries received CTs that are being used to support significant policy reforms. In these cases, the local currency counterpart is funding new A.I.D. supported activities. An exceptionally large CT was also provided to Sudan in FY 1985. Reductions in the AEPRP and in provisions for Sudan largely account for a reduced CT estimate in FY 1986. Africa CTs in FY 1986 are still estimated to be 71% above the 1982-FY 1984 average, but the total accounts for only 3.5% of all CTs in FY 1986.

IV. Comparative Analysis: Strengths and Weaknesses of Cash Transfers and CIPs

As a means of providing balance of payments support the Commodity Import Program (CIP) is the major alternative to the cash transfer. Balance of payments assistance can also be provided through sector or project assistance entailing substantial local currency outlays. However, in such cases, the focus of mission attention must necessarily be on the programming and utilization of the local currencies purchased, and on the use of the dollars earmarked to cover the direct import requirements of the program or project, and not on the disposition the central bank might choose to make of the dollars used to purchase the local currencies required for the sector or project assistance.1/ We shall, therefore, focus on the pros and cons of the cash transfer versus the CIP.

A. Pros and Cons of the Cash Transfer

Advantages

The main advantages of cash transfers in comparison with CIPs are as follows:

1. Immediate disbursement: Amounts urgently required for balance of payments support can be disbursed immediately. If tranching takes place, the first can be disbursed immediately,

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1/ To place on A.I.D. missions the double responsibility of monitoring the use of the dollar counterpart to the local currency purchased in addition to supervising the implementation of the sector or project assistance, does involve a heavy administrative burden. The practice of such double checking and accounting can also run into strong opposition from the host government. For these reasons, A.I.D. has not so far followed the practice of monitoring the utilization of dollar funds transferred to governments as a *quid pro quo* for local currency programmed either for sector activities or for projects.

while subsequent tranches can be disbursed over the year as particular conditions precedent or covenants are met, or in accordance with a pre-arranged schedule. Importers can be provided immediate access to urgently needed foreign exchange for importation of essential raw materials and intermediate goods. Thus, balance of payments assistance can be provided much faster than in the case of the CIP, where the provision of foreign exchange depends on the rate of utilization of the program.

2. Immediate local currency generation: In some countries, the local currency counterpart generated by the sale of the dollars is urgently needed to implement particular projects or to finance high priority activities. Counterpart is generated much more rapidly in the case of a cash transfer.

3. Maximum flexibility: Even where the cash transfer is conditioned on the purchase of an equivalent amount of raw materials, intermediate and capital goods from the United States, the cash transfer provides much greater flexibility than a CIP. For example, if the country obtains a first tranche of $30 million of a $100 million annual cash transfer, that $30 million might be used immediately after it is received to pay off an IMF credit or an overdue bank loan. This would not be in violation of the agreement even when an "attribution" process (defined below) is called for, as long as the country can show, after a lapse of one year, that it has imported $100 million of eligible commodities from the United States as specified in the agreement. The CIP would not furnish the same degree of flexibility.

4. Cash transfers permit purchase in the most favorable markets. A cash transfer allows importers in the host country to buy in countries offering the most favorable prices. On the other hand, a CIP may force a country to shift its procurement from the

cheapest source to the United States. While this is an advantage from the viewpoint of those anxious to promote U.S. exports, it may well be a drawback from the viewpoint of LDCs that may be forced to pay higher prices for the goods they require in order to take advantage of the CIP.

5. A cash transfer allows manufacturers and importers to obtain their raw materials, spare parts, etc. from their established suppliers. A CIP often forces them to shift to new suppliers which involves inconvenience and may cause further delay in procuring the goods.

6. A cash transfer does not require setting up the administrative procedures that characterize the CIP. The latter generally requires one or more full-time specialists to provide information, draw up eligibility lists, monitor advertisements in U.S. commercial journals, advise applicants on the solicitation of competitive bids, etc.

7. Cash transfers provide greater leverage in obtaining policy reform. In view of the strong preference that host countries have for cash transfers as opposed to CIPs (for the various reasons detailed above), the cash transfer is more effective than the CIP in obtaining the cooperation of host governments to implement policy reforms that A.I.D. considers most important from the viewpoint of achieving the objectives of a stabilization program and setting the basis for long-term growth. Such reforms may include but are not limited to reducing budget deficits and the amount of credit expansion to the public sector, adjusting the exchange rate, eliminating price and exchange controls and revising the tax or tariff structure to promote economic growth.

Main Disadvantages of Cash Transfers

1. Purchases cannot be channeled to U.S. exporters or shippers as directly as in the case of the CIP.

Evaluation: While this argument has validity as far as the immediate and direct impact of the cash transfer is concerned, it cannot be inferred that the cash transfer would necessarily entail, in the long-run, a lesser amount of U.S. exports than a CIP. In the first place, when it is difficult for a country to make purchases from the United States, it may be necessary to permit CIP procurement in other markets. Secondly, even if the CIP is fully tied to financing U.S. exports, the country may have purchased all of these goods from the United States in any event, so long as it had the same amount of foreign exchange available. In other words, U.S. exports would be larger with a CIP than with a cash transfer only to the extent that tying induced the country to alter its sources of procurement overall, i.e., to the extent that the CIP resulted in diverting imports from other markets to the United States. In these circumstances, there would be some "additionality" associated with the CIP. However, even in this case, it is possible that the same result could be obtained by negotiating an attribution agreement with a cash transfer. Under such agreements, the recipient can be required to provide evidence of imports from the U.S. equivalent to the amount of the cash transfer, though these need not necessarily be directly financed with CT dollars. In order to fulfill this requirement, the country might have to make purchases from the United States additional to what it otherwise would have done to the same extent as it would with a CIP.

Cash Transfer funds, of course, can be used to finance imports from other than U.S. sources. However, U.S. exports will increase anyway to the extent that the third country dollar earnings from such procurement are then spent on imports from the United States. (The same point, of course, applies to non-U.S. purchases under a CIP.) In any event, to the extent that cash transfers do not result in export of U.S. goods and services, they become claims on the United States, and will be recorded only in the capital accounts. In that case, although U.S. exports are not supported immediately, neither are there any immediate real costs to the United States. The transaction is purely financial. Of course, to the extent that the funds are invested in the United States, they can earn a return that will involve a real cost to the U.S. economy.

2. A more serious shortcoming of the cash transfer is the fact that it is more difficult to track its use than in the case of a CIP. Ways of dealing with this problem are discussed in Section V below. However, it should be realized that because of the fungibility of foreign exchange resources, CIP funds can also be used indirectly for unauthorized purposes.

B. Pros and Cons of the CIP

<u>Advantages</u>

The main advantages claimed for the CIP as a means of providing balance of payments support are:

1. Funds are tied to U.S. procurement, a process that can stimulate U.S. exports. (This argument is discussed below under "Evaluation of the CIP".)

2. The program assists U.S. merchant shipping.

3. The funds in the program are subject to financial control, thus preventing their illicit diversion or resort to fraudulent prices to effect capital flight (evaluated under c. below).

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Best available copy -- pages 19 and 20 are missing private procurement entails, on the average, a lapse of at least 4-6 months from time of submission of individual purchase requests to final approval. The delay is much longer in the case of public sector procurement.

It is true that the CIP may have some favorable effect on the demand for U.S. shipping; however, to the extent that it compels developing countries to import more of their bulk commodity imports in U.S. bottoms, they are likely to receive less for their aid dollars owing to the higher cost of U.S. shipping services.

The argument that CIP funds are subject to greater financial control, thus preventing illicit diversion, is also subject to qualification. While it is true that the CIP enables the A.I.D. mission (and U.S. auditors) to trace the disposition made of funds equal to those in the CIP, substantial *de facto* diversion is still possible owing to the fungibility of all foreign exchange resources.

There are two ways of preventing such fungibility, both of which are likely to be difficult to implement. The simplest would involve the strict imposition of an additionality requirement. Alternatively, A.I.D. would have to supervise or monitor all foreign exchange allocations of the central bank. Clearly, this would be highly objectionable to the host government.

In sum: The analysis to this point has established that: (1) the cash transfer is a demonstrably superior instrument for providing effective and quick disbursing balance of payments assistance for which the CIP is a very imperfect substitute, suffering from a number of drawbacks from both the host government and U.S.G. points of view; (2) as a result, the cash transfer provides A.I.D. with greater leverage for encouraging the host country government to undertake needed policy reforms; (3) on the other hand, the CIP is much less vulnerable to the charge of misuse of USG funds, though the fungibility of foreign exchange resources makes it difficult or impossible to ensure that all balance of payments assistance provided is in fact utilized for the purposes intended, regardless of the modality that such assistance assumes.

The question addressed in the following section is whether the cash transfer mechanism can be strengthened by establishing certain restrictions on host country utilization of the cash transfer.

V. Procedures to Improve Control

The procedures examined in this section are designed to retain, to the extent possible, the fast disbursing nature and flexibility of the cash transfer, while providing a measure of accountability for the use made of A.I.D. funds. Here only the modalities designed to provide some degree of control over the disposition of the dollars from the cash transfer are considered. Two alternatives, both already in use, will be discussed. The first is in operation in most Latin American/Caribbean countries receiving U.S. balance of payments assistance; the second is applied only by El Salvador. Both may be considered for wider application.

The first procedure involves the "strong" attribution of the utilization of the USG cash transfer. For example, if the USG transfers $100 million to a country for balance of payments support, that country may be required to show, twelve months following disbursement of the transfer, that $100 million worth of eligible commodities were imported from the United States or other eligible sources during that period. The documentation could include, for example, an import license, the central bank's approval of the application for foreign exchange, a proforma invoice, a bill of lading, a customs declaration and host government certification that the merchandise was received.

The second and more stringent procedure is currently followed in El Salvador. While the attribution procedure described above has been retained, there is the additional requirement that the ESF contribution be placed in a separate dollar account. A separate ESF dollar account mechanism was created in June, 1985. The account is maintained at the Federal Reserve Bank of New York and is managed by El Salvador's Central Reserve Bank. Funds expended from the separate account are used to finance the importation for the private sector of raw materials, intermediate and capital goods, spare parts and agricultural inputs from the United States, Central American Common Market countries (except Nicaragua), and Panama. In addition, Petroleum and petroleum derivatives may be imported from approved countries under Geographic Code 941. This procedure has the advantage of segregating the U.S. contribution, thus preventing the funds in the account from being used for non-authorized purposes.

The table below provides a fairly detailed breakdown of the utilization of $100 million in ESF balance of payments assistance to El Salvador in 1985.

Table 8.

El Salvador ESF Separate Dollar Account
Status as of November 1, 1985

($ millions)

Disbursed to BCR*	BCR Paid	BCR Reserved**	BCR Available
100	89	10.6	0.4

Expenditures by category of import transaction

Raw materials	$ 4.6
Intermediate goods	22.8
Capital goods	15.9
Spare parts	.3
Agricultural inputs	7.0
Petroleum	49.0
Total	$ 99.6

* BCR-Central Reserve Bank

** Funds reserved are considered the same as funds paid out since they are allocated to specific letter of credit transactions and are not available for other uses.

An evaluation by the AID/El Salvador Desk notes that the mechanism has functioned well to date. Still, A.I.D. has not been happy with the procedure. The Desk's memorandum describes it as "cumbersome," presumably because it complicates the central bank's administrative procedures and diminishes the flexibility with which it can manage its foreign exchange resources.

Aside from administrative problems, the separate account mechanism suffers from three other disadvantages: (1) it may require special legislation; (2) it reduces the host country's flexibility in utilizing the foreign exchange provided; and (3) it is unlikely to work in countries that have no foreign exchange controls and are able to operate with a single market-determined foreign exchange rate.

The greatest obstacle to setting up a separate account system may be the requirement for special legislation. A.I.D.'s General Counsel staff has indicated that the attempt to set up an account in the central bank without such legislation could trigger compulsory use of CIP procedures, notably, the elaborate procurement mechanism built into Reg. 1. When the decision was made to set up a separate account for El Salvador, the GC suggested the inclusion of special language in the International Security and Development Cooperation Act of 1985. A provision along the lines of the proposal, quoted below, was adopted and incorporated into the relevant Continuing Resolutions.

> Such funds (from the A.I.D. cash transfer) shall be used solely for the purchase of materials essential for productive economic activity and development, with particular emphasis and priority on the import needs of agrarian reform in the agricultural sector, and shall be maintained in a separate account in the Central Reserve Bank of El Salvador and not commingled with any other funds. Furthermore, such funds may be obligated and expended notwithstanding provisions of law which are inconsistent with the cash transfer nature of the assistance. . .

It would not be practical to have special legislation for each LDC for which a separate account mechanism might be applied. What could be considered is enabling legislation authorizing the Administrator to negotiate with host country governments the establishment of separate accounts on the Salvadoran model.4/

4/ Such legislation, in the GC's opinion, would have to be sought by both A.I.D. and State.

It is important that the Administrator be authorized and not required to negotiate such separate account agreements, since countries which regard our cash transfers as payments for base rights, and not as balance of payments assistance, might well resist setting up such special accounts. Furthermore, this approach may not prove practical in other instances. Each country situation would have to be examined.

A second problem is the inflexibility that results from the fact that cash in a special account cannot be used for non-authorized purposes at any time during the year, such as paying off an obligation to the IMF or a commercial bank in months when foreign exchange reserves are low, and replacing that sum later when, for example, seasonal export proceeds are received.

Finally, the mechanism may be difficult to implement under a unified market-determined exchange rate system with no foreign exchange controls or import licensing since importers would have no incentive to utilize the A.I.D. funds in the special account (which presumably would entail some administrative procedures) when they can freely purchase foreign exchange at the same rate with no strings attached.

In spite of these obstacles and drawbacks, it might be useful to consider extension of the separate fund mechanism to other countries receiving cash transfers for general balance of payments/budget support. For many cash recipients of A.I.D. balance of payments support, a cash transfer placed in a separate central bank account may well be preferable to a CIP owing to the administrative complexity and delays that characterize the latter.

The device of establishing a separate account can be supplemented with other "controls". In fact, there may be pressures to do so. Thus, A.I.D. was impelled, in the case of El Salvador, to respond to Congressional and press criticism by establishing a "price checking unit" in the central bank. The criticism was that over-invoicing of imports and underreporting of exports were being widely used by private traders to export capital, thus dissipating U.S. balance of payments assistance. A U.S. consulting firm was employed to establish a price checking unit in the central bank, provide training to central bank personnel, establish price checking procedures, computerize price information, etc. The A.I.D. mission has reported substantial progress in curbing capital flight through such abuses. Similar price checking units have since been established in a number of other countries (e.g., Costa Rica, Honduras, Dominican Republic).[5/]

Another "control" already in wide use is the programming (jointly by the A.I.D. mission and host government) of local currency counterpart funds generated by the cash transfer. The mission subsequently obtains periodic reports from the host country government on the use made of the local currency funds. (See Annex III.)

Can the two alternative procedures discussed in this section be transferred to other LDCs receiving substantial cash transfers for balance of payments support? Our tentative conclusion is that such extension might be seriously considered in some cases, but

5/ The best way of curbing capital flight through misquoted prices or other devices is to establish a unified exchange rate set at--or close to--the equilibrium level and to deal with the other factors that promote capital flight. The need for a price checking mechanism arises mainly under conditions of over-valued official exchange rates, exchange controls, and political instability which generate incentives to export capital.

may not be feasible in others. It may have to be on a selective basis. Countries receiving substantial transfers as part of USG political commitments, or which regard U.S. cash transfers as their "due" in payment for base rights, might not accept either the attribution process or the setting up of a separate account. If political or economic considerations dictate that cash transfers be continued, these countries may have to be exempted from any of the restrictions that these alternative procedures would entail. In other cases, extension of the attribution process (without creating a special account) might well be considered as it requires no special legislation or change in U.S. regulations.

Adoption of the special account system is more complex. The question that must be addressed in this regard is whether it would be desirable to propose legislation designed to endow the Administrator with discretionary authority to negotiate agreements requiring central banks to set up a separate account for A.I.D.-provided balance of payments assistance. While this procedure would offer the advantage of reducing the vulnerability of the cash transfer to the criticism of illicit use or diversion, it would leave the USG vulnerable to the charge of discriminating among countries receiving cash transfers depending upon political expediency. Admittedly, there is no justification for imposing restrictions on cash transfers in the case of some countries (e.g., in Latin America and the Caribbean) while exempting others (the base rights countries), since the basis for the distinction is essentially a matter of U.S. leverage. While such arbitrary discrimination is already implicit in current cash transfer procedures, the enactment of new legislation and the extension of the El Salvadoran model to some countries (and not to others) might exacerbate the issue.

VI. Summary and Conclusions

There has been a substantial increase in ESF balance of payments assistance since 1979. Between FYs 1981 and 1986, ESF BOP assistance (cash transfers and CIPs) increased from $1.5 billion to $3.7 billion, while cash transfers alone increased from $1.2 billion to $3.2 billion. In FY 1986, it is expected that cash transfers to Israel and Egypt will account for 70% of total cash transfers. In addition to our commitment to the peace process in the Middle East, the substantial increase in cash transfers over the last few years was influenced by our increased assistance to the Central American and Caribbean countries which have experienced growing balance of payments and debt service problems. U.S. cash transfers to Portugal and the Philippines also increased significantly.

The basic rationale for balance of payments/budget support assistance is to (1) meet U.S. political commitments resulting from the Camp David accords (to Israel and Egypt), (2) provide assistance to countries where the U.S. has strategic bases or landing rights (e.g., the Philippines, Turkey, Portugal); 3) meet the need for fast-disbursing balance of payments assistance in countries experiencing serious BOP difficulties and in which the U.S. has major security/political interests; (4) support essential economic policy reform to promote stabilization and/or economic growth; and (5) purchase the local currency required to implement A.I.D. project and sector activities. In any specific case, more than one of these justifications may be present.

Balance of payments assistance constitutes a significant part of the A.I.D. program. While its relative importance may decline if the balance of payments problems of some of our major aid recipients improve, no substantial reduction in needs is anticipated in the near future owing to the seriousness of the balance of payments and debtservicing problems of a large number of LDCs. In any event, balance of payments/budget support assistance is expected to remain a basic tool of U.S. foreign policy.

This paper has focused heavily on the relative merits of the cash transfer as a vehicle for delivering balance of payment assistance. It is easier to trace the direct disposition made of U.S. funds with a CIP, and this provides A.I.D. with a better defense against charges of misappropriation and capital flight. However, the CIP was found to suffer from a number of disadvantages. These include implementation delays, lack of flexibility to meet priority foreign exchange requirements, a substantial administrative burden on the A.I.D. mission, higher procurement costs, and the tendency to reinforce a country's disposition to maintain dual exchange rates and foreign exchange controls.

On the other hand, the cash transfer provides the advantages of immediate disbursement, fast local currency generation, maximum flexibility in the use of foreign exchange, allowing the host country to import freely at competitive world market prices, avoidance of setting up cumbersome administrative procedures, and compatibility with movement toward liberalization of the foreign exchange system.

Cash transfers are indeed vulnerable to the criticism that the funds can be used to finance capital flight or for other undesired purposes. Commodity import programs are less vulnerable to such charges since they are linked to the purchase of eligible commodities from the United States or other authorized sources. However, even in this case, it can be shown that the diversion of foreign exchange to illicit uses is possible owing to the fungibility of all foreign exchange resources.

In order to retain the quick disbursing and maximum flexibility characteristics of the cash transfer while reducing its vulnerability to the criticism of misuse, two alternatives were considered. They constitute intermediate or compromise solutions. The first is the "strong" attribution process already common in the Central American/Caribbean region which requires that host countries provide documentation showing that imports of eligible goods equal to the cash transfer are in fact procured from the United States or other authorized sources. A second solution is the requirement that a special account be established in the central bank that would prevent commingling the U.S. cash transfer with other central bank funds. Such a system would require special legislation, which now exists for El Salvador, the only country where a separate account has been established.

Consideration could also be given to extending and/or intensifying the monitoring of the use made of local currency resources in countries where this is not being done on a systematic basis.

Annex I

Cash Transfer Procedures

1. CDSS/ABS/Action Plan.

Ideally there should exist an approved CDSS under which a proposed cash transfer is shown to be an integral part of our overall assistance strategy for a given recipient. Timing and operational details would be further elaborated in the ABS and Action Plan. If timing permits, an activity description will be included in the country program section of the Congressional Presentation.

2. Initial Proposal.

The concerned mission will prepare a PAIP (Program Activity Initial Proposal) or surrogate document for Washington Review. This document is the non-project assistance (NPA) analogue of the PID. In LAC the usual practice is to require an "ESF Concept Paper", which, inter alia, substitutes for the PAIP. Some missions will simply send in descriptive cables outlining the proposed cash transfer.

Approval Authority: regional AA with PPC concurrence.

Redelegation Authority: Based on AID/W review of brief program assistance descriptions, Assistant Administrators are encouraged to delegate to the field, where there is a full mission, PAIP approval authority for proposals up to $20 million (and amendments which result in life of project funding up to $30 million), and which based on PPC review, do not raise significant issues. (Because the dollar amounts often exceed $20 million, and as a regular practice of the Bureaus even when the amount is less than $20 million, the Geographic Bureaus require AID/W approval of non-project assistance PAIPs.)

3. The PAAD.

The Program Assistance Approval Document is the authorizing document. It is the NPA analogue of the Project Paper, and contains: the overall rationale for the cash transfer, the dollar amounts, covenants and conditions, the exchange rate, provision for local currency disposition (if any), grant or loan terms, the satisfaction of statutory check list items, and other salient details. Usually, as part of the PAAD or annexed thereto will be a detailed macroeconomic assessment. This document is prepared by the mission based on Washington feed-back on the initial proposal.

Approval Authority: regional AA with PPC concurrence

Redelegation Authority: When a PAIP has been approved in Washington for non-project assistance over $20 million, or an amendment resulting in life of non-project assistance funding over $30 million, Assistance Administrators may redelegate the authority to approve the PAAD to Principal Officers of field offices based on policy, programmatic and staffing considerations. (In practice, Bureaus require AID/W approval of PAADS.)

4. CN, Apportionment, and Allotment.

If the program and/or amounts differ from the CP, the bureau on mission request makes a Congressional Notification (through LEG).

If an apportionment does not exist, the bureau through PPC will seek one from OMB. With these in place, the bureau will issue an allotment of funds.

5. The PAA.

The Project Assistance Agreement is the obligating document, a bilateral agreement with the host government committing both parties to the terms and conditions of the PAAD. If this is not worked out with the host government in the process of developing the PAAD, it will be negotiated with that government based on the approved PAAD.

Approval Authority: normally the Mission Director.

6. The PAAA.

The Program Assistance Agreement Abstract is prepared by the geographic bureau and is used to record the obligation in the official financial records.

7. The Transfer of Funds.

Either mission or AID/W may request FM to make the transfer. The request should specify the dollar amount, the bank and account into which the deposit is to be made, the allotment symbol, and should state that the appropriate CPs have been met.

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Major Forms of Cash Transfers

Cash transfers vary substantially from region to region, even from country to country, with regard to the size of the allocation, the purposes they are designed to accomplish, and the degree to which utilization is monitored and documented. The description presented below is illustrative rather than comprehensive.

Israel: Israel is by far the largest recipient of ESF CT assistance, with obligations of $910 million in FY 1984 and $1.95 billion in FY 1985. While an attribution process is nominally in force--viz. a commitment that eligible commodities equal to the value of the cash transfer are to be purchased in the United States--in fact, no documentation is submitted. The only requirement is a letter drafted periodically by the Government of Israel indicating that such procurement took place.

There is, however, an agreement that the same amount of grain imported in prior years from the United States under a CIP would continue to be imported from the United States, and that the 50% shipping rule (i.e., 50% of the grain to be shipped in U.S. bottoms) would apply. Such shipments are estimated to amount to about $300 million per year.

Egypt: Cash transfers to Egypt amounted to $102 million in FY 1984 and $350 million in FY 1985. There is no requirement that documents be submitted to show how the U.S. dollars are used. Thus, there is no attribution process as far as U.S. dollars are concerned. However, the Egyptian government has furnished a letter in both FY 84 and FY 85 indicating that it was committing itself to import in bulk agricultural commodities from the United States an amount equal to average imports over the last five years under CIPs. The 50% shipping rule applies to these imports.

The local currency counterpart to the cash transfer is programmed for development purposes, mainly for development of the housing and health sectors.

Egypt is also the recipient of a CIP in addition to the cash transfer.

The Philippines: A cash transfer of $45 million was provided in FY 1985. There is no attribution process as far as utilization of the U.S. dollars is concerned. No documentation is required to show disposition of the dollar funds. The emphasis in the Philippine program (as in Egypt) is on the acquisition and utilization of local currency, which is programmed mainly for construction of schools, roads, health facilities and other infrastructure. Some of this local currency is also made available to finance projects sponsored by the Asian Development Bank.

Jamaica and Dominican Republic: In FY 1985 Jamaica and the D.R. received CTs of $80.5 million and $95 million, respectively. The attribution process is in force in both countries, i.e., documentation is required showing importation of eligible commodities from the United States in an amount equal to the amount of the cash transfer. The documentation (submitted *ex post*) includes pro forma invoices, bills of lading, bank documents and customs receipts. In addition, there is a price checking unit in Jamaica that checks on the prices of major import and export products to prevent over- and underreporting to finance capital flight.

Honduras and Costa Rica: In FY 1985 CTs to Honduras and Costa Rica amounted respectively to $147.5 million and $160 million. Both of these countries use the attribution process and require submission of appropriate documentation. Both countries have a price checking unit in operation.

El Salvador: In FY 1985 El Salvador's CT amounted to $243.5 million. El Salvador has an attribution process similar to those for the LAC cases noted above. It also has a well-functioning price checking unit operating in the central bank. The distinctive feature of the El Salvador program is that, beginning in 1985 (and at U.S. insistence), a separate account for the U.S. cash transfer was set up in the central bank which segregated these funds. However, the source of procurement was broadened to include the CACM countries designated as participants in the Caribbean Basin Initiative, and for the purchase of oil and petroleum products, to all Code 941 countries.

African Countries: A.I.D. provides cash transfers to African countries for a variety of reasons:

1. To assist the countries that provide base rights, communications facilities, naval refueling facililties, and overflight and landing rights to the United States.

2. To assist countries that are also of strategic importance to the United States.

3. To assist countries under the African Economic Policy Reform program (AEPRP) which commenced in FY 1985: these are countries that have agreed to undertake substantial policy and institutional reform to provide appropriate incentives for economic growth. The program is designed to give the U.S. a voice in major policy dialogue issues in Africa. Countries in the program in FY 1985 were Mali, Zambia, Malawi, Rwanda and Mauritius.

With regard to monitoring, the general underlying feature of our programs in Africa is that the control is on the utilization of local currencies, not on tracing the use made of dollar funds.

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The local currencies are programmed jointly by the A.I.D. mission and the host country for general development purposes. There is no attribution process or required submission of documentation for the dollar funds.

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Local Currency Generation and Uses

A. The Magnitude of ESF Non-Project Aid and Expenditure of Local Currency Generations

A.I.D. participation in recipient country decisions on the uses of non-project generated local currency is expected and possible everywhere but Turkey, Israel and Spain. The following are the levels of ESF dollar obligations and local currency expenditures for the years FY 84, 85 and 86 (excluding Turkey, Israel and Spain). The local currency data is drawn from the ABSs submitted during the spring and summer of 1985.

($ Millions)

Bureau	FY 84 Actual		FY 85 Estimated		FY 86 Planned	
	ESF Obs.	LC Expend.	ESF Obs.	LC Expend.	ESF Obs.	LC Expend.
AFR	206	61	287	105	202	208
ANE	540	63	745	397	679	620
LAC	362	236	797	525	531	617
TOTAL	1,108	360	1,829	1,027	1,412	1,445

The Local Currency Use Plans in general do not distinguish between local currencies emanating from CIPs or Cash Transfers. But it should be noted that very few bilateral programs provide non-project aid in both the CIP and Cash Transfer mode. All LAC non-project aid is via Cash Transfer. Only Egypt in the ANE region receives both CIP and Cash Transfer assistance. In Africa a few countries have relatively small programs of both kinds.

B. The Extent of A.I.D. Involvement in the Uses of Local Currency Generations

Both among and within regions, the Missions' narrative descriptions of the local currency program vary considerably--from mostly detailed discussion of accounting practices to a general listing of broad uses to which the recipient country might attribute the funds. It can be inferred, though, that the form the aid takes--CIP or Cash Transfer--has little effect on the extent a bilateral AID mission incorporates the use of the currencies as a resource to advance the A.I.D. development strategy for a country. Also, it appears that the level of detail that is possible in programming the use of the currencies does not significantly differ between CIP and Cash Transfer generations.

C. Variations Between CIP and Cash Transfer Generated Local Currencies

Examination of the 1985 Local Currency Use Plan narratives and numbers indicates several notable differences in how the currencies accumulate, are spent, and are documented.

Local currencies from Cash Transfers both accumulate much faster and are spent-out more rapidly than CIP generated currencies. Local currency from Cash Transfers is usually available shortly after the dollars are obligated because the dollars usually are disbursed to the country right away, and they then are put to use immediately to finance incoming or already delivered imports in exchange for the local currency. It is A.I.D.'s policy preference that local currency accumulations from non-project aid be spent as quickly as possible. The policy to spend local currency quickly, the practice of providing Cash Transfers annually, the large amount of dollars committed, and the equivalently rapid accumulation of large amounts of local currencies together lead to rapid use of the local currency.

Local Currencies from Cash Transfers are used to finance the recipient countries' recurrent budget more often than CIP