BY THE U.S. GENERAL ACCOUNTING OFFICE

Report To The Secretary Of State, Secretary Of The Treasury, And Administrator, Agency For International Development

U.S. Development Efforts And Balance-Of-Payments Problems In Developing Countries

Since the oil price increases of 1973, developing countries have taken on large external debts. Much of the increase has come from private credit markets. The increased debt, along with high interest rates and depressed markets for exports, has led to increased balance-of-payments pressures, often of severe proportions.

The International Monetary Fund is the principal source of official balance-of-payments support, with the United States also assisting some countries through specific balance-of-payments support and to some extent through AID's development assistance programs. In some of the most severe cases, the United States has agreed to reschedule part of a country's official debt, a process carried out primarily through the Departments of State and the Treasury. In the face of increased incidence of balance-of-payments problems, this report discusses U.S. approaches to providing assistance to developing countries experiencing balance-of-payments problems and an action which can be taken to improve those approaches.

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FEBRUARY 14, 1983

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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

NTERNATIONAL DIVISION

B-206712

The Honorable George P. Shultz
The Secretary of State

The Honorable Donald T. Regan
The Secretary of the Treasury

The Honorable M. Peter McPherson
Administrator, Agency for International
Development

This report discusses U.S. approaches to providing assistance to developing countries experiencing balance-of-payments problems and actions which can be taken to improve those approaches.

The report contains a recommendation to the Administrator, Agency for International Development, on page 16. As you know, 31 U.S.C. §720 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the Senate Committee on Governmental Affairs and the House Committee on Government Operations not later than 60 days after the date of the report and to the House and the Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

We are sending copies of this report to the Director, Office of Management and Budget, and to the cognizant congressional appropriation and authorization committees.

Frank C. Conahan
Director

GENERAL ACCOUNTING OFFICE REPORT TO THE SECRETARY OF STATE, SECRETARY OF THE TREASURY, AND ADMINISTRATOR, AGENCY FOR INTERNATIONAL DEVELOPMENT

U.S. DEVELOPMENT EFFORTS AND BALANCE-OF-PAYMENTS PROBLEMS IN DEVELOPING COUNTRIES

D I G E S T

Total external debt owed by developing countries increased from $70 billion to $424 billion during the 1970s and was projected to reach $626 billion in 1982. Recent attention has focused on the countries with the largest debt, such as Mexico, an oil exporter. However, many countries accumulating this debt were oil importers. They faced a combination of greatly increased oil import bills and stagnant international markets for their exports. To meet their needs for external resources, developing countries turned increasingly to private banks which were recycling surplus funds from the oil-exporting countries. By the end of the decade, such countries were paying record-high interest rates and were experiencing rising debt service costs. For some, inappropriate economic policies added to their difficulties. As a consequence, the incidence and severity of balance-of-payments difficulties rose and the number of countries seeking debt rescheduling increased. These events have placed severe strains on developing countries by increasing their balance-of-payments difficulties and have presented the industrial countries providing development assistance with new challenges. A balance-of-payments crisis has the potential to disrupt a country's economy and threaten its development program.

The Congress has become increasingly concerned about the rising external debt burden of developing countries. More recently, the immediate concern has been about the soundness of the international banking system. However, in a time of concern over national budget growth, calls have also increased for more effective use of the resources made available to the U.S. foreign assistance program. In response to these concerns, GAO reviewed U.S. programs designed to assist countries with balance-of-payments problems. GAO focused on (1) what the United States can contribute to easing developing countries' debt burden pressures while ensuring the most effective and efficient use of

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its limited development assistance resources and (2) what relationship debt rescheduling has to a U.S. bilateral development program in the rescheduling country.

GAO focused on an analysis of the balance-of-payments difficulties in three Latin American countries--the Dominican Republic, Costa Rica, and Peru--each with different economic circumstances, and that are experiencing different stages of balance-of-payments difficulties. The Dominican Republic, an oil importer heavily dependent upon sugar export earnings, has experienced a rapid economic deterioration since 1980. Peru, a marginal net oil exporter, was recovering after a 1978 debt rescheduling when, by 1981, declining prices for its exports once again brought serious balance-of-payments problems. Costa Rica, which once enjoyed stable economic growth, is experiencing a severe economic crisis.

U.S EFFORTS TO EASE DEBT BURDEN PRESSURES

The Agency for International Development (AID) administers U.S. balance-of-payments support programs in some developing countries in addition to carrying out the U.S. bilateral development assistance program. AID is faced with the need to balance its development mandate to provide basic human needs with the increased incidence of balance-of-payments difficulties, a task made more difficult given limitations to foreign assistance resources.

Balance-of-payments problems can have an adverse effect on development assistance projects. However, AID finds it difficult to reorient its development assistance program to the evolving balance-of-payments problems. Some AID missions may hesitate to propose action when they identify a serious deterioration in a country's balance-of-payments situation because of the difficulties the missions perceive in adjusting a development assistance program and justifying balance-of-payments tools. It appears AID program planners and missions may lack guidance as to which countries and at what point the United States will consider assistance in deteriorating balance-of-payments situations. (See p. 15.)

RECOMMENDATION

GAO recommends that the Administrator, AID:

--direct AID missions to develop an action plan, when they determine that a country's balance-of-payments situation has affected AID's ongoing development assistance effort, for AID to consider, taking into account all the factors which restrict the Agency's role. The plan could include an assessment of whether AID's ongoing projects continue to be appropriate, how they relate to other donor activities, whether the country is following appropriate economic policies, and an estimate of the country's resource needs. (See p. 16.)

DEBT RESCHEDULING AND DEVELOPMENT ASSISTANCE

Since the 1950s, the United States has rescheduled debts of developing countries when they faced imminent default. During the 1970s, developing countries resorted to debt rescheduling in increasing numbers and the trend is continuing in the 1980s.

The United States officially considers debt rescheduling to be a financial matter with the objective of providing maximum loan repayments to the United States. The United States ties a debt rescheduling agreement to an International Monetary Fund (IMF) stabilization agreement and seeks maximum debt repayment consistent with the debtor country's economic recovery. Thus, despite the primarily financial aspects of debt rescheduling, its goals are, to some extent, compatible with the goals of development assistance (see p. 29).

AGENCY COMMENTS AND GAO'S EVALUATION

AID and the Department of the Treasury disagreed with GAO's proposal in the draft report to develop a policy for taking earlier action in response to potential balance-of-payments problems. The agencies stated that earlier action by AID could affect the critical role of IMF in dealing with balance-of-payments problems in developing countries. The report recognizes the key role of IMF and the revised

GAO recommendation does not intend for AID to try to assume the role of IMF. However, developing countries have generally turned to IMF as a last resort when their balance-of-payments problems have reached crisis proportions. AID noted it is aware that balance-of-payments support may be required in some cases to preserve prospects for future development.

AID expressed concern that the recommendation, if implemented, would result in a departure from AID's development mandate. GAO does not advocate that AID become a balance-of-payments support agency. However, in some cases of extreme balance-of-payments difficulties, AID does provide support, and our concern is that missions have adequate guidance on the circumstances under which AID will provide such support.

GAO had proposed in chapter 3 that the Departments of State and the Treasury and AID provide for greater integration of debt rescheduling with the U.S. bilateral development assistance program in the country being rescheduled thus enhancing the objectives of both programs. The three agencies expressed concern that such a proposal tends to equate debt rescheduling with development assistance and could adversely affect the official U.S. position that debt rescheduling is strictly a financial matter. They would also see this as a departure from congressional intent on debt rescheduling. Because of these concerns GAO is not making a recommendation.

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ABBREVIATIONS

AID	Agency for International Development
GAO	General Accounting Office
IDB	Inter-American Development Bank
IMF	International Monetary Fund

CHAPTER 1

INTRODUCTION

BACKGROUND

The accumulation of debt is part of the natural process of financing a developing country's growth. However, in the past decade, great changes have taken place in (1) the nature, amount, and source of developing countries' debt and (2) the perception of the impact of debt on development.

In the mid-1960s, over one-half of the net flow of financial resources to developing countries were grant flows, grant-like flows, and direct foreign investments. In the aftermath of oil price increases in 1973 and 1974, however, the total debt and debt servicing obligations of the developing countries rose rapidly.

According to the World Bank, during the 1970s, total debt owed by developing countries increased from approximately $67.7 billion to $439 billion (in current dollars), a 6-fold increase. Debt from official sources increased about 4-fold from $35 billion to $154 billion in this period. Privately held debt increased from $29 billion to $270 billion, a 9-fold increase. Although some of this increase can be attributed to inflation, debt to private creditors increased approximately 28 percent annually over the decade until, in 1980, fully 35 percent of the total debt owed by developing countries was owed to private creditors as compared to 10 percent in 1970.

According to the World Bank, bilateral development assistance decreased in real terms, due to increasing economic weakness in the major Western industrial countries. Although they increased their lending, the multilateral development banks were not able to keep pace with the financial needs of the developing world. Consequently, developing countries turned increasingly to private banks which were recycling surplus funds from the oil-exporting countries.

The World Bank reported that, at the end of 1981, developing-country debt totaled $517 billion, of which $334 billion was owed to private banks. The remaining $183 billion was owed to governments and international lending institutions. Recent debt figures indicate Mexico and Brazil alone account for approximately $168 billion of the total developing-country debt of which about $136 billion is owed to private banks. Argentina has the third largest developing-country debt, approximately $37 billion, of which about $28 billion is owed to private banks.

The accumulation of private debt helped ease the immediate burden of adjustment to higher oil prices and to the general deterioration of the international economic environment, but the tremendous increase in such debt has also raised some concerns. The higher interest rates and generally shorter maturities of private debt have been of greatest concern because, by 1979, a greater proportion of developing country debt was privately held.

Private credit, unlike official credit, is not generally subsidized and, thus, carries a higher interest rate. According to the World Bank, interest payments of all developing countries rose to $51 billion in 1981 and are likely to be $56 billion in 1982, more than twice the level in 1979.

Another concern, relating directly to development, is the falling share of official capital in the debt portfolio. In the past, private capital complemented official capital. During the 1970s, however, private capital was used to substitute for reduced official capital flows in some countries as well as to meet increased capital needs. Official capital, including the bilateral programs, is used largely for longer-term development projects, whereas private capital often requires greater emphasis on rapid returns and, thus, may be used for shorter-term needs.

Many developing countries have had a difficult time making the necessary economic adjustments to the greater amount of private debt as well as the higher costs of such debt. The result has been greater difficulty for developing countries to service their private debt and yet maintain economic growth. An increase in the number of countries experiencing severe balance-of-payments problems has occurred. The problems are more often long-term problems rather than cyclical, and more countries have turned to the International Monetary Fund (IMF) for balance-of-payments assistance.

THE ROLE OF IMF

IMF is the principal source of official balance-of-payments finance. IMF credit is made available on the condition that the drawing country maintain or adopt policies calculated to correct, in due time, the payments deficit in question. IMF conditions can require some severe economic austerity measures, such as reducing public sector expenditures and increasing tax revenues, which governments may find very difficult to impose without experiencing domestic social and political pressures.

The length of IMF financing has in some cases been as long as 3 years to reflect the more difficult policy adjustments a country has had to make. The level of IMF financing nearly doubled between 1979 and 1980 and increased substantially again in 1981,and IMF has enlarged access to its resources. As of September 30, 1981, IMF had stand-by or extended agreements with 41 non-oil developing countries. By late 1982, it appeared that

the major Western industrialized nations were going to agree to increase the IMF fund resources although the amount had not been determined.

DEBT MANAGEMENT

During the 1960s, debt management emphasis in developing countries centered on short-term payments imbalances and foreign exchange shortages resulting from inappropriate domestic policies, a poor crop year, or an external event such as a depressed export market. These setbacks were viewed as reversible--they simply required some counter-cyclical borrowing to redress the temporary shortfall. This process was perceived as taking place without a change in a country's longer-term indebtedness. The same approach to balance-of-payments problems was used, and appeared to work, after the first oil price increase in 1973. The increased costs for oil imports were covered through increased borrowing, often at interest rates lower than the rate of inflation, and by a short period of increased commodity export prices.

At first, most developing countries attempted to absorb the much greater oil price increases in 1979 and 1980 with the same approach. However, the changes in the macroeconomic environment of the late 1970s have made the 1960s approach to debt management and balance-of-payments problems inadequate. Consequently, the number of developing countries experiencing serious balance-of-payments problems has increased which will require more than an upturn in export commodity prices for solution.

Despite a recent slump in oil prices due to an oversupply, oil import costs remain high relative to many third world exports, including primary commodities. Oil producers, such as Mexico, that predicated development policy on an assumption that oil prices would remain high have also had to adjust to declining world trade. According to the World Bank, low-income countries have suffered far more from falling commodity prices and export volumes than they have gained from falling petroleum prices. The trend toward slower real export growth and deteriorating terms of trade in the non-oil developing world is not likely to be reversed until real economic growth is accelerated in industrial countries. Debt for most developing countries and middle-income countries continues to rise even higher relative to gross national product at the same time these countries face stagnant export earnings, record-high interest rates, and declining levels of official assistance.

Developing countries are aware that they will have to make some basic economic structural adjustments, but present conditions will make it difficult for them to successfully do so on their own. Such adjustments, which include reorienting domestic resources more into export production, curbing import demand, and strengthening current account balances, can require many years even under the best conditions.

Because developing countries have already borrowed extensively, they are now less able to finance adjustment and growth. More countries are requesting debt rescheduling, a financial last resort. A few countries are repeating the rescheduling process almost annually. Even without any further external shocks, the creditworthiness of developing countries has been strained. Some countries could become too great a risk to attract sufficient private capital. Development programs will inevitably suffer as financial pressures increase and more attention is given to short-term financial requirements rather than long-term development.

OBJECTIVES, SCOPE, AND METHODOLOGY

The objectives of this review were to determine the impact of external debt-related problems on developing countries within the context of U.S. assistance programs to developing countries and to identify changes that could improve the effectiveness of such programs. To do this, we examined the trend toward greater balance-of-payments difficulties in developing countries and asked the following questions.

1. What can the United States contribute to easing developing countries' debt-burden pressures while ensuring the most effective and efficient use of limited U.S. development assistance resources?

2. What relationship does debt rescheduling have to a U.S. bilateral development program in the rescheduling country?

We began with a general study of the causes and effects of greater developing-country debt and the resulting trend toward greater balance-of-payments problems. Beyond that, we focused on U.S. development assistance programs, the U.S. approach to debt rescheduling for developing countries, and the prospects of continued private capital being available to developing countries.

We examined AID's frame-of-reference in providing balance-of-payments support and analyzed specific mission responses to balance-of-payments problems. We focused on Latin America where many countries have achieved, or are approaching, middle-income status. 1/ We selected three middle-income countries with AID programs for detailed study: the Dominican Republic, Costa Rica, and Peru. These countries do not have the largest debt among developing countries, but they are experiencing serious balance-of-payments difficulties. Peru rescheduled its debt in 1978, and Costa Rica is expected to reschedule in 1983. The Dominican Republic's balance-of-payments situation has deteriorated rapidly since 1980.

1/The World Bank defines middle-income countries as those with a per capita income of more than $410.

Table 1 gives some comparative statistics. Together, the three countries provide a wide spectrum of debt problems as well as variation in U.S. official response to the problems.

Table 1

Comparative Statistics for Fiscal Year 1980

	Dominican Republic	Costa Rica	Peru
Population (millions)	5.4	2.2	17.4
Per capita Gross National Product	$1,160	$1,730	$930
External Public Debt (millions)	$1,750	$2,415	$8,435
Debt Service Ratio 1/	21.5	16.4	31.3

1/Debt service as a percentage of exports of goods and services.

Source: World Bank Annual Report 1982 and the World Development Report 1982.

We examined the U.S. official debt rescheduling process to determine whether its objectives were adequately integrated with U.S. development objectives. We reviewed U.S. Government and other studies of the process as well as selected documents related to specific rescheduling cases. We also interviewed U.S. Government, multilateral development bank, and private industry officials involved in the debt-rescheduling process. Our review was conducted in accordance with generally accepted government auditing standards.

Work was performed at AID, and the Departments of the Treasury and State in Washington, D.C., the World Bank, Inter-American Development Bank (IDB), and IMF headquarters, also in Washington, D.C. Work was also done in conjunction with U.S. bankers in New York and Miami; U.S. AID missions and embassies; host-country government agencies; and private business enterprises in the Dominican Republic, Costa Rica, and Peru. We conducted extensive interviews and reviewed pertinent documents and studies with all of these organizations.

In the U.S. banking sector, we held interviews with representatives of 12 large- and medium-sized banks and obtained selected studies related to our review. In each of the three countries selected as case studies, we interviewed U.S. AID mission and embassy officials and held up to 15 meetings with officials representing host-government agencies, universities, multilateral and other bilateral donors, and U.S. and domestic private businesses.

CHAPTER 2

U.S. ROLE IN PROVIDING BALANCE-OF-PAYMENTS SUPPORT IN DEVELOPING COUNTRIES

Balance-of-payments difficulties can have an impact in developing countries by slowing the development momentum and, in some cases by adversely affecting previous development progress. IMF is the principal source of official assistance for a country with a balance-of-payments crisis. The country must generally make appropriate economic policy adjustments as a condition of IMF assistance. The United States generally supports the IMF balance-of-payments program and can provide further support through its development assistance program or through other assistance programs more specifically designed for balance-of-payments support.

AID is generally called upon to carry out U.S. balance-of-payments support programs. This is not an easy task because AID development assistance programs are difficult to quickly reorient toward providing balance-of-payments assistance. The programs providing specific balance-of-payments support are difficult to justify, especially in a time of tight budgets. Other agencies, such as the Departments of State and Agriculture, share responsibility for decisions regarding which countries receive assistance under these programs. Another complication is that countries experiencing balance-of-payments difficulties are often reluctant to make the necessary economic policy adjustments short of a crisis.

Balance-of-payments problems can have an adverse effect on development assistance projects. However, AID does not appear to have placed much emphasis on earlier Agency action which might help those countries trying to deal with their balance-of-payments problems. When AID does tackle the balance-of-payments problem, it may be reacting to a severe crisis, possibly threatening U.S. development accomplishments. It appears AID's missions may be hesitating to take earlier actions, partially because AID lacks an adequate approach for taking such action.

BALANCE-OF-PAYMENTS PROBLEMS AFFECT DEVELOPMENT PROJECTS

Balance-of-payments problems in the three developing countries we visited slowed development momentum and, in some cases, affected previous progress. Operational budgets were being reduced to cover only minimum expenses, mostly salaries. We were told that in the Dominican Republic and Costa Rica, some completed projects were not being maintained. In Peru, the

increasingly limited operational budget was making it difficult for the government to continue funding some of the completed projects. In all three countries, donors reported that there were instances where reduced investment budgets were constraining governments from meeting their share of project costs, thus delaying project implementation and increasing project costs. In Costa Rica and the Dominican Republic, we were also told that, in some cases, projects to meet urgent development problems, but with long-term payoffs, are being delayed indefinitely.

Project assistance provided by both multilateral and bilateral donors generally requires recipient governments to finance part of the cost of each project's counterpart funding. AID officials said counterpart funding is where balance-of-payments difficulties often first appear. In each of the three countries we visited, most donors with whom we talked said counterpart funds were more difficult to obtain as the balance-of-payments situation deteriorated. The United States had negotiated agreements with each of the three countries whereby the host government was required to use part of the local currency generated by Public Law 480, Title I, to satisfy counterpart funding requirements on some AID projects.

We were told that as hard-pressed governments attempted to drive down their deficits, they often had to reduce their longer-term investment budgets. Both World Bank and IDB projects were delayed because the Dominican Republic's government sought funding to meet its contract obligations. In Peru, one donor reported that projects may extend from an originally planned 3 years to 6 years because of government inability to supply counterpart funds. The consequent increase in project costs has forced some contractors to withdraw from projects, thereby causing more delays. Costa Rica has likewise experienced problems in supplying counterpart funding.

Various donors in the three countries reported other examples of how reduced operational budgets affect maintaining current levels of economic development. In Costa Rica, we were told that the Ministry of Health sometimes finds it can no longer pay for needed medical supplies. In the Dominican Republic, the country's road network has suffered because the government cannot afford all the machinery needed for maintenance, and money for training and maintenance in the Ministry of Health has been reduced. IDB has also urged the Peruvian Government to place renewed budgetary emphasis on maintaining its current road system. We were told sugar processing plants in the Dominican Republic have lost efficiency due to poor maintenance. Further, one U.S. embassy official said repairs on a dam are being delayed.

We found, in some cases, AID's ongoing projects are potentially jeopardized by tight operational budgets. In Costa Rica, mission officials stated that the country could no longer afford

some of AID's more complex projects which had been started before the crisis. In Peru, the government has not resumed previous AID projects in education despite government interest and even enthusiasm for them. In Costa Rica, mission officials also indicated that institutions which AID has created or strengthened may not survive the current crisis. They also said bankruptcy threatens a major development bank and that the savings and loan industry faces possible insolvency. It also appears that a rural electric cooperative may not be able to survive the current recession.

The balance-of-payments crisis was not just an economic problem in either Costa Rica or Peru. Donor and other officials observed that the economic crisis threatened to become a political/social problem with repercussions for the democratically elected governments. For example, some Costa Rican and U.S. Government officials believe that the country may face the threat of instability if the government cannot offer reasonable hope to the rapidly increasing ranks of the unemployed. In Peru, donors reported popular frustration over continuing poverty and inflation. The frustration stemmed from what several donors concluded are unrealistic national expectations for the new government after 12 years under the military government.

Unfunded programs, poor maintenance, and lost opportunities for new projects all reflect the impact a balance-of-payments crisis has on development projects. This cost to development activities occurs when the government must devote its financial and managerial resources primarily to stemming the country's rapid economic decline. In the three countries we visited, AID was, in varying degrees, trying to assist governments in dealing with their balance-of-payments difficulties. (See app. II.)

AID'S ROLE AND POLICY IN PROVIDING BALANCE-OF-PAYMENTS SUPPORT

To some extent, the United States can provide balance-of-payments support through its development assistance program. However, in a 1981 message to AID missions, the AID Administrator stated:

> "AID will continue its policy not to provide development assistance for strictly balance-of-payments support."

The United States can also respond to balance-of-payments problems in developing countries with quick-disbursing programs, generally known as non-project assistance, which AID also administers.

One such program is the Economic Support Fund which provides quick disbursing aid most often through commodity imports or cash transfers. Another program is Public Law 480, Title I, under which agricultural commodity imports are

provided, thus alleviating budget pressures in the agricultural sector. Although AID administers these programs, the Agency does not unilaterally decide which countries are to receive such assistance. For example, the Department of State and the Department of Agriculture are primarily responsible for Economic Support Fund and Public Law 480, Title I decisions, respectively. AID's housing guarantee program also has been used to provide balance-of-payments support. Under this program, funds from the U.S. private sector, guaranteed by the U.S. Government, provide long-term financing for low-income shelter and urban upgrading programs in developing countries.

AID policy

An AID policy handbook states it is AID policy to encourage and support developing country efforts to expand their output of essential goods and services, to distribute them equitably, and to improve the quality of life of their people. The policy notes that AID resources are also used to support U.S. foreign policy objectives, mostly in the form of economic assistance used to provide direct balance-of-payments support. In such cases, it is AID policy to help developing countries reach the point where circumstances favor replacing economic assistance with development assistance.

In his 1981 message to AID missions, the AID Administrator stated that

> "* * *in view of the dramatic increase in balance-of-payments problems, stabilization programs with IMF involvement, and requests for non-project assistance, there is a need for better analysis of the content and impact of IMF programs and of the appropriate strategies for using U.S. assistance particularly P.L. 480, to encourage and support needed policy reforms."

A year later, in July 1982, in another message to AID missions, the Administrator emphasized linking resource transfers through AID-funded projects and programs to "technical or institutional change or policy reform," but specified that policy change was not an end in itself, but rather a means to achieving development objectives.

Many AID officials we talked to in Washington said the increase in balance-of-payments pressures in developing countries was adding difficulties to maintaining AID's development programs. Some AID officials told us the increase in balance-of-payments difficulties had caused some discussion within AID as to how to more effectively deal with these difficulties. Such discussion appears to have centered around a possible middle-income policy. We were told that AID has, from time to time, considered whether the Agency needs such a policy to deal

with what may be development problems common to middle-income countries.

In 1979, the Development Coordinating Committee, which is chaired by AID, issued a study entitled, "U.S. International Economic Policy Towards 'Middle Income' Developing Countries." The study was in response to a House Committee request for a report on the future of U.S. development assistance programs toward middle-income countries. The committee was concerned that U.S. bilateral development assistance was being reduced or terminated to countries classified as middle-income countries at a time when those countries still had a great need for external assistance to support their development efforts. The committee called on AID to review its development objectives toward middle-income countries and to consider what resources the United States was willing to devote to their development.

The study concluded that the middle-income countries, as a group, will be able to finance any short-term, balance-of-payments problems in the near future and that present institutional arrangements are adequate to handle most short-term problems. The conclusion was based on the expanded resources of IMF, access to private capital markets, and, on an individual basis, access to various bilateral and other official arrangements.

Even though the study concluded the present system was adequate, it did raise a question about whether a new instrument, especially focusing on balance-of-payments, needed to be developed to address the "few individual cases of severe short balance-of-payments imbalance." The study said that, for the United States

> "the policy issue arises of whether and how to assist individual MICs 1/ if their short-term financing needs cannot be fully met by existing multilateral instruments. There are limitations to the use of most existing aid and monetary instruments for balance-of-payments support, and at times, the amount of private capital it can obtain. As a result, when a particular MIC which we wish to help has run into difficulties, we have had to resort to ad hoc arrangements using a package of instruments which usually has included Supporting Assistance, P.L. 480, CCC, 2/ EXIMBANK 3/ credits or HIG 4/ and, on occasion, development assistance. One of the policy issues that needs to be addressed is whether this policy has been effective in promoting U.S. interest in MICs or whether a more structured approach is needed

1/Middle-Income Countries.
2/Commodity Credit Corporation.
3/Export-Import Bank.
4/Housing Investment Guarantee Program.

and if the latter, what such an approach might consist of."

Caribbean Basin Initiative

In February 1982, the United States announced a program to assist nine countries in the Caribbean, and Central and South America which are facing major economic difficulties. The program, called the Caribbean Basin Initiative, is a package of trade, investment, and aid measures linked to recipient country adoption of sound stabilization and recovery programs. The AID Administrator has stated that, as part of the initiative strategy, the Economic Support Fund will be used primarily for balance-of-payments support and stimulation of local, private enterprise. He has stated that these countries have a desperate need for fast-disbursing assistance to fill their large balance-of-payments gaps.

Table 1

Economic Support Fund Assistance Under the Caribbean Basin Initiative Fiscal Years 1982-83

	FY 1982 budget	FY 1982 Supplemental request	FY 1983 request
	($ millions)		
Central America			
Costa Rica	20	70	60
El Salvador	40	128	105
Honduras	0	35	25
Nicaragua	20 1/	0	0
Caribbean			
Dominican Republic	0	40	0
Haiti	0	5	0
Jamaica	40	50	55
Belize	0	10	0
Suriname	0	0	1
Caribbean Regional	20	10	30
Latin America Regional	0	2	50
Total	140 1/	350	326

1/Includes $20 million earmarked for Nicaragua in the fiscal year 1982 International Security and Development Cooperation Act.

Source: Agency for International Development.

THE AID PROGRAM IN THREE CASE STUDY COUNTRIES

There are some general similarities between the U.S. assistance programs and economic difficulties in Costa Rica, Peru, and the Dominican Republic. 1/ Costa Rica is experiencing a severe economic crisis, and AID officials believe Costa Rica's ability to continue development while maintaining its tradition of democratic government is being threatened. It also appears that if the Dominican Republic and Peru experience still greater economic difficulties, the United States could well face a situation similar to that which it faces in Costa Rica where U.S. objectives are threatened. U.S. officials in all three countries stressed achieving U.S. objectives, as related to encouraging democracy. The three countries illustrate the difficulties AID faces in trying to deal with balance-of-payments problems in developing countries.

By the mid-1970s, AID was phasing out its assistance program in Costa Rica. It had a few fairly sophisticated projects providing technical assistance in agrarian reform, energy and natural resource planning, banking, and science and technology. According to AID officials, the AID programs in the Dominican Republic and Peru are basically development assistance programs which provide some balance-of-payments support, such as through the Public Law 480, Title I program. As noted, the Dominican Republic also receives some Economic Support Funds under the Caribbean Basin Initiative.

In the Dominican Republic and Peru, the missions have moved beyond basic development projects as the countries have progressed in management and absorptive capacities. This is especially true in the Dominican Republic where we were told the government is now ready to expand successful AID projects in health into new communities. AID is also supporting a natural resources management project in the Dominican Republic which has attracted the support of other donors. In Peru, the mission had supported an education project which a mission official said is now ready for the government to carry out in other locations.

Adjustment from AID's orientation to development assistance projects to a response to balance-of-payments problems is a difficult and long process. Part of AID's response has been to assist the host government in meeting counterpart project costs. By negotiating agreements whereby the host governments commit some of the local currency generated under Public Law 480, Title I to be used as counterpart funds on AID projects, AID achieves partial insulation from economic difficulties. Consequently, in all three countries, AID officials were much less worried about their program being disrupted due to a lack of counterpart funds than other donors with whom we spoke.

1/See app. I and II, respectively, for detailed discussion of the economic situation and the AID program in each of the three countries.

Under circumstances of potential further economic deterioration, AID appears to be faced with a dilemma. Because increasingly sophisticated projects are part of a country's development progression, such projects also claim increasing amounts of the country's resources which can become difficult for the country to provide. The AID program in Costa Rica illustrates the problem AID faces when a balance-of-payments crisis occurs. AID's program in Costa Rica was inflexible and not only unable to respond to the crisis but also claiming significant host-government resources which were becoming increasingly scarce.

The mission had apparently seen the crisis developing over a 2-year period but had not taken any significant action, in part, due to inaction on the part of the previous government of Costa Rica. When assistance from the multilateral banks did not materialize as expected, the mission requested Economic Support Fund assistance for Costa Rica. However, AID did not initially approve the request because, according to mission officials, the United States did not recognize the severity of the situation.

In Peru, both embassy and mission officials presently hope Peru will be able to solve its balance-of-payments problems, short of a crisis. However, some mission officials believe it would take a serious political as well as economic crisis to get significantly more U.S. assistance for Peru. They also noted that Peru's economy is large and that it is not likely that the United States would be able to provide as large a proportion of balance-of-payments support as it is, for example, providing in Costa Rica. U.S. officials pointed out that the World Bank and IDB had increased their activities in Peru. They said an approach for the United States in Peru might be to support economic structural adjustment projects such as those of the World Bank.

In the Dominican Republic, it appears AID may find itself in a situation similar to that in Costa Rica. Mission officials in the Dominican Republic appeared to be much less convinced that the country was heading for a balance-of-payments crisis than most other donor, host-government, and private business officials we talked to. U.S. officials told us the Government of the Dominican Republic had made policy adjustments in response to its balance-of-payments problems. The mission's approach to much of the AID program appeared to be "business as usual." The mission had adjusted its AID program in agriculture and energy to help address the longer-term needs in those sectors, but mission officials viewed the problems as essentially of a short-term cyclical nature. AID officials in Washington subsequently told us the Dominican Republic had very serious economic structural problems which would take many years to correct.

In Costa Rica and the Dominican Republic an important factor in the economic difficulties was that they were holding elections in 1982. This caused a reluctance to act on the part

of the outgoing governments. Nevertheless, in Costa Rica, once AID saw the serious nature of the crisis, the mission was able to take the lead in arranging a plan of emergency assistance measures even before the newly elected government took office. In each of the three countries we visited, the mission's response to the country's economic difficulties appeared to be most affected by the constraints they perceived in getting AID to respond to a deteriorating balance-of-payments situation.

Difficulties AID faces

Many important factors complicate AID's potential role in dealing with balance-of-payments problems. AID officials in Washington and at AID missions told us that the Agency is limited in what it can do within its Development Assistance program to help address balance-of-payments problems in a developing country. They pointed out the types of problems they can face in trying to assist a country to overcome balance-of-payments difficulties. Reorienting AID's program to include balance-of-payments support in AID's project assistance can be a difficult and lengthy process. For example, accelerating disbursement on existing projects may not be feasible. We were told such acceleration is not generally easy because projects often have an established pace of progress. Secondly, accelerated project disbursement also tends to accelerate counterpart requirements.

Changing sector focus within a mission's Development Assistance program is another possible adjustment to increasing balance-of-payments pressures. Specifically, the mission can concentrate its assistance in sectors such as energy, which accounts for significant import costs. Agriculture can also be an important target in this respect in those countries where food imports become a steady drain on foreign currency resources. However, such a change in focus can take a long time to plan and implement.

The nature and magnitude of the balance-of-payments problems, compared to the size of AID's program, also affect AID's ability to help. A country's first step toward solving its balance-of-payments problems must be to adopt appropriate economic policies. Donors, including the United States, generally support an IMF stabilization program and often prod the country to take the appropriate policy adjustment action. AID officials said that the U.S. Development Assistance program in a country is generally too small for AID to influence the recipient country's policy. However, some AID officials also said it is very difficult to obtain any additional assistance even for those countries which are attempting to make the appropriate policy adjustments.

AID officials told us the United States can, in some instances, ally its program with other donors, such as the World Bank, to help increase the so-called leverage. However, such donor cooperation is not always possible because donors do not

always agree on development objectives. Such cooperation is further complicated by each donor having a set of procedures to follow in project planning, execution, etc., which can make a timely coordinated effort very difficult. Consequently, AID officials termed U.S. influence, in this respect, as often marginal at best.

Limited U.S. budget resources are another constraint on AID. AID missions, working with U.S. embassy economic officials, analyze a host country's economic situation and appear to be able to provide AID with some warning of potential balance-of-payments problems which might impact on U.S. programs and overall U.S. interests in the country. However, given AID's tight budget and the competition for its resources, AID officials said getting additional financial assistance is not an easy matter for a country with increasing balance-of-payments problems.

Despite these constraints on AID, when a country's balance-of-payments problems become as severe as in Costa Rica, AID finds itself trying to adjust its Development Assistance program in response to the crisis. The Administrator and many officials we talked to in AID recognize the special difficulties balance-of-payments problems can cause for development efforts. AID's response has been to emphasize tying AID project assistance to beneficial economic policy adjustments by the recipient country.

CONCLUSIONS AND RECOMMENDATION

AID is faced with achieving a difficult balance between maintaining development projects and reacting to the increasing incidence of balance-of-payments difficulties. Even though IMF is the principal source of official balance-of-payments assistance, United States' bilateral assistance can also be used to provide such assistance. AID can, to some extent, use its development assistance programs to provide balance-of-payments support. AID also administers U.S. programs providing specific balance-of-payments support.

The Caribbean Basin Initiative is intended to provide short-term balance-of-payments support for nine developing countries in the Caribbean, and Central and South America. The United States has also provided emergency assistance to some countries with severe balance-of-payments crises, such as Costa Rica. However, there does not appear to be a clear AID policy on what can be done to assist countries with increasing balance-of-payments difficulties. AID is concerned that the Agency not become a balance-of-payments support agency at the expense of its development mandate. We share AID's concern, but in some cases of extreme balance-of-payments difficulties AID does provide balance-of-payments support and our concern is that missions have adequate guidance on the circumstances under which AID will provide such support.

In the three countries we visited, the AID missions appeared to react to the environment of increasing balance-of-payments problems with uncertainty and approached their potential role of providing balance-of-payments support with some hesitation. The difficulty of adjusting a development assistance program and the even greater difficulty of justifying balance-of-payments assistance, particularly in a time of tight budgets, encourages such hesitation. The result appears to be a tendency toward "business as usual" until events force some action, as in Costa Rica. In that country, the AID program is now designed primarily to provide balance-of-payments support and has increased from approximately $5.3 million in fiscal year 1981 to a proposed $90 million for fiscal year 1983.

AID officials, in general, appear to believe the Agency has the appropriate tools available, such as the Economic Support Fund, to provide specific balance-of-payments support. However, AID program planners and missions appear to lack guidance as to which countries and at what point the United States will consider assistance in deteriorating balance-of-payments situations. This could lead to otherwise successful AID projects possibly becoming a burden for the recipient country in the present economic environment. In Costa Rica and the Dominican Republic, it appeared the government may not be able to sustain certain development projects under the present economic circumstances. In Peru, there were indications the government was accepting projects that might, in the future, overextend its ability to sustain them.

The United States' policy is to rely on IMF as the primary source of balance-of-payments support. In support of IMF, over the past 2 years, AID has also emphasized a policy of tying its development programs to positive economic policy adjustments in the recipient countries. AID officials have acknowledged that some countries have adopted appropriate economic policies even without an IMF agreement but are still having difficulty adjusting on their own. AID's resources are clearly limited and the United States cannot hope to assist every developing country with balance-of-payments problems. However, we do not believe the only alternative is to react when the problems reach crisis proportions.

Therefore, we recommend that the Administrator, AID:

--direct AID missions to develop an action plan, when they determine that a country's balance-of-payments situation is deteriorating to the point of affecting AID's ongoing development assistance effort, for AID to consider, taking into account all factors which restrict the Agency's role. The plan could include an assessment of whether AID's ongoing projects continue to be appropriate, how they relate to other donor activities, whether the country is

following appropriate economic policies, and an estimate of the country's resource needs.

Agency comments and our evaluation

We received comments from AID and the Department of the Treasury concerning this chapter's conclusions and recommendation. We modified the wording of our recommendation to avoid the possible misinterpretation which concerned these agencies.

AID commented that earlier action by AID could affect the critical role of IMF in dealing with balance-of-payments problems in developing countries. The Department of the Treasury also emphasized the role of IMF and expressed the view that the Department of State and AID have made notable progress in the last 2 years in tailoring U.S. assistance to the needs of countries experiencing balance-of-payments problems.

Our report recognizes the key role of IMF, and our revised recommendation does not intend for AID to assume what has been the role of IMF in dealing with balance-of-payments problems in developing countries. Our report also points out that the level of AID's resources is, in fact, a limiting factor in what AID can do to assist developing countries with their balance-of-payments problems. The limited resources, however, make it all the more important that AID use them as effectively as possible. We believe our recommendation could lead to AID's program being more reflective of the economic environment in developing countries and thus enhance more effective use of AID resources.

Developing countries have generally turned to IMF as a last resort when their balance-of-payments problems have reached crisis proportions. AID and the Department of the Treasury comments appear to suggest that it may not be possible to assist a developing country address its balance-of-payments problems before the country seeks IMF assistance.

Both AID and the Department of the Treasury stressed the fact that many developing countries are following inappropriate macroeconomic policies and suggested that our report should acknowledge that these policies must be adequately adjusted before balance-of-payments problems can be successfully addressed. Appendix I of the report contains considerable discussion on this point with respect to our case study countries; however, we accepted the agencies' suggestion and have included more information on the importance of appropriate economic policies in this chapter.

AID officials and others have said that in some cases a developing country may be following basically sound policies but still have great difficulty in its balance-of-payments. In such cases we believe AID should assess whether it would be in the U.S. interest to make a special attempt to assist the country to

avert a crisis. AID appears to agree on this point. It commented that "AID is of course aware that balance-of-payments support may be required in some cases to preserve prospects for future development."

AID officials generally believe they have the necessary tools for providing balance-of-payments support whether it be accelerated disbursement on traditional development project assistance or cash transfers such as through the Economic Support Fund. The difficulty, we concluded, is a lack of specific policy guidance on the circumstances under which the United States will apply these tools, short of a recognized crisis. AID, in its comments, stated that the existing policy framework is explicit and generally adequate. However, an AID policy development paper prepared for the Administrator, after our draft report was prepared, contained a conclusion similar to ours and recommended a policy clarification.

AID expressed concern that our earlier proposed recommendation would result in a departure from AID's development mandate. We do not advocate that AID become a balance-of-payments support agency and recognize that AID's resources are limited. However, increasingly, there have been cases where AID has become a balance-of-payments agency when a country's problems have reached crisis proportions.

AID also expressed concern that the implementation of our proposed recommendation, by providing balance-of-payments support at an early stage, could serve to encourage developing countries to adopt only partial economic adjustment programs. This misses our point. In those instances where AID concludes a country is experiencing balance-of-payments problems but is not doing enough to help itself through appropriate economic policies, we believe AID should, at a minimum, reevaluate its program from the standpoint of host-country sustainability and ensure that U.S. development assistance projects remain the appropriate projects for the country.

AID stated it expects a developing country to make a realistic assessment of whether the country can handle its balance-of-payments problems on its own, including through prudent private borrowing, or whether it will need official balance-of-payments assistance. AID also stated that earlier assistance may ease the immediate balance-of-payments problem but may do little to help deal with the underlying causes. As stated above, AID is also concerned that once a country receives balance-of-payments assistance it may adopt only partial economic adjustment measures. This may be, but we believe that, when AID development assistance efforts are threatened, AID should consider use of its assistance tools, in coordination with other donors, in those countries which have adopted appropriate economic policies but are still experiencing increasing balance-of-payments problems.

CHAPTER 3

U.S. GOVERNMENT DEBT RESCHEDULING IN DEVELOPING COUNTRIES

The United States participates, on a case-by-case basis, in rescheduling U.S. Government loans to developing countries facing imminent default. The debt-rescheduling arrangement is contingent upon whether the rescheduling country agrees to an IMF stabilization program. The U.S. objective in a debt rescheduling is to maximize repayment to the United States consistent with economic recovery in the debtor country. Although debt rescheduling is considered to be a financial matter, its goals are, to some extent, compatible with the goals of development assistance.

The U.S. Government rescheduling approach was designed to respond to the rare instances of balance-of-payments crises in the 1950s. Increased rescheduling by developing countries occurred in the 1970s and, during this period, some countries rescheduled more than once. Debt reschedulings can affect U.S. Government programs when loan repayments are delayed and proposed program funding is reduced. It appears that the pace, magnitude, and number of participants in reschedulings could continue in the 1980s.

THE DEBT-RESCHEDULING PROCESS

The debt-rescheduling process, an ad hoc flexible mechanism for the renegotiation of official debt, was developed during the 1950s to give financial breathing space when a nation was about to default. Rescheduling consists of a lengthening of the maturities generally on principal repayments due in a given period--usually 1 year. The debt-rescheduling procedure was developed to meet occasional economic emergencies, but the rising frequency and severity of balance-of-payments problems have made recourse to debt rescheduling more common.

Official debt reschedulings generally take place within the framework of the "creditor club mechanism." The most frequently used creditor forum is "the Paris Club," so called because it is chaired by the French Treasury. Although there are no formal rules for rescheduling, the Paris Club has over the years evolved a set of informal written procedures. The general procedures are as follows: (1) the request for a Paris Club meeting is initiated by the debtor country; (2) the creditors agree to convene only after the debtor is facing imminent default; and (3) a rescheduling agreement is concluded only after the borrower has agreed to implement an economic stabilization program normally supported by IMF.

Only official debt is rescheduled through the Paris Club. Commercial bank loans and other private credit are generally rescheduled separately. To date, World Bank and other development bank loans have not been rescheduled at the Paris Club.

Only the borrower and creditor governments can formally participate in the rescheduling. Other governments, the World Bank, IMF and other interested parties can observe.

Generally, these debt-rescheduling procedures have been adhered to, but increasingly, exigencies, such as the need for repeat rescheduling, have led to some exceptions. According to the Treasury Department, these exceptions were justified by the extreme nature of the political and/or economic crises confronting debtor nations.

U.S. approach to debt rescheduling

The major U.S. objective in a debt rescheduling is to maximize repayment to the United States, consistent with the country's economic recovery. The United States generally uses the Paris Club to reschedule debt owed to the U.S. creditor agencies. The Treasury Department is responsible for drawing up the U.S. position and the Department of State negotiates the agreement at the Paris Club. All U.S. agencies with loans outstanding to the debtor nation, including AID, have an opportunity to review and comment on the draft U.S. negotiating position. Other interested agencies such as the Office of Management and Budget also have an opportunity to review the U.S. negotiating position.

The National Advisory Council is the coordinating body for formulating the U.S. debt-rescheduling policy. All major creditor agencies are represented on the Council, 1/ and once the overall rescheduling agreement is reached at the Paris Club, the agencies individually negotiate a repayment schedule for their loans with the debtor country consistent with the Paris Club agreement. The overall agreement resulting from the Paris Club is an executive agreement that is submitted to the Congress. The Congress then has 30 days in which to comment or request further action. Barring comment, the agreement goes into effect.

The executive branch has no specific overall statutory authority to reschedule or cancel debt. The exact terms and form of debt rescheduling which can be provided depend largely on the legislative authority establishing the particular creditor agency loan program. In 1970, the Attorney General issued an opinion partly in an effort to harmonize the practices of the various agencies in a major rescheduling operation. He held that even in the absence of explicit statutory authority to reschedule loans made under a particular program, the executive branch has broad inherent authority to modify the terms of loans beyond the limits set forth in the relevant authorizing legislation when a situation of imminent default exists and such action is likely to maximize repayment to the United States.

1/The Department of Defense is not a member of the Council.

The U.S. Government issued official guidelines on the U.S. rescheduling policy in 1978. From time to time, the Congress has requested clarification of U.S. rescheduling policy and has even considered legislation requiring prior congressional approval for debt relief. However, this would be inconsistent with the emergency nature of the debt-relief process and so the Congress accepted the current agreement format. In 1978, after the Congress had again considered legislation to change the process, the Council spelled out the "rules" of U.S. rescheduling policy which would enable the United States to act expeditiously to extreme balance-of-payments crises.

In brief, the National Advisory Council policy states that, during extraordinary circumstances, the United States will reorganize debt on a case-by-case basis. Reschedulings are normally limited to payments due not more than 1 year following reorganizing negotiations. According to the Council, debt rescheduling is considered a strictly financial mechanism and should not be given as a form of development assistance. In general, for the United States to grant a rescheduling, a debtor nation must

--be at the point of imminent default;

--be willing to reorganize its debt through the creditor club mechanism;

--agree to implement an economic program designed to respond to the conditions and deficiencies which led to the rescheduling; and

--grant no creditors preferred status, including private creditors and others not party to the agreement.

Debt rescheduling trends in the 1970s

The number and magnitude of Paris Club debt reschedulings increased significantly during the 1970s, and the process is no longer a rarely used measure. It appears that these trends could continue in the 1980s. Between 1956 and 1974, there were 30 reschedulings involving 11 countries; about $7 billion in debt was rescheduled. For the period 1975 to 1980, there were 16 reschedulings for nine countries, involving debts of about $9 billion. In 1981, the United States participated in rescheduling debt for nine nations; 1/ in 1982 the number was six. Twelve repeat reschedulings for ten nations (including commercial reschedulings) have occurred since 1977. The following tables show the debt reschedulings since 1956 and illustrate the growing frequency and magnitude of reschedulings.

1/The debt rescheduling negotiations for Turkey began in 1980.

Table 1
International Debt Rescheduling Exercises
1956-78 1/

Year	Country	Total amount rescheduled	Amount of U.S. debt rescheduled
		$ millions	
1956	Argentina	500	0
1959	Turkey	400	0
1961	Brazil	300	0
1962	Argentina	240	0
1964	Brazil	200	44.5
1965	Chile	96	43
1965	Turkey	220	15
1965	Argentina	76	18
1966	Ghana	170	0.511
1966	Indonesia	247	51
1967	Indonesia	95	23
1968	India	300	27
1968	Peru	58	0
1968	Indonesia	85	22
1968	Ghana	100	0.141
1969	Peru	70	0
1970	Indonesia	2,100	215
1970	Ghana	25	0
1971	India	92	9
1971	Yugoslavia	59	59
1971	Egypt	145	145
1972	Cambodia	2	0
1972	Chile	258	110
1972	Pakistan	234	51
1972	India	153	29
1972	Cambodia	2.5	0
1972	Turkey	114	0
1973	Poland	32	32
1973	Pakistan	103	23
1973	India	187	29
1974	Ghana	290	0
1974	Chile	460	232
1974	Pakistan	650	196
1974	India	194	45
1975	Chile	230	95
1975	India	167	0
1976	India	160	0
1976	Zaire	170 (est.)	46
1977	India	n.a.	0
1977	Zaire	200 (est.)	68 (est.)
1977	Sierra Leone	n.a.	0
1978	Turkey	1,100 (est.)	225 (est.)
1978	Peru	456	n.a.

1/Official debt only.

Source: Office of Monetary Affairs, Department of State.

Table 2

International Debt Rescheduling Exercises 1/

1979-81

Year	Country	Total amount rescheduled	Share of commercial banks	Share of Paris Club
		$ millions		
1979	Jamaica	447.93	447.93	0
1979	Sudan	55.33	0	55.33
1979	Turkey	788.94	525.96	262.98
1979	Zaire	36.19	0	36.19
1979	Togo	3	0	3
1980	Nicaragua	182.88	182.88	0
1980	Sudan	447.67	447.67	0
1980	Sierra Leone	2	0	2
1980	Liberia	6	0	6
1981	Jamaica	105.07	105.07	0
1981	Nicaragua	579.12	579.12	0
1981	Bolivia	460	460	0
1981	Turkey	3,594.06	3,199.59	394.47
1981	Pakistan	186	0	186
1981	Zaire	480.81	398.09	82.72
1981	Togo	7	0	7
1981	Madagascar	6	6	0
1981 2/	Central African Republic	48	2	46

1/Official and private debt.
2/1981 data does not include the Paris Club reschedulings of Liberia, Poland, Senegal, and Uganda.

Note: 1982 Paris Club reschedulings were for Madagascar, Malawi, Rumania, Senegal, Sudan and Uganda.

Source: Office of Monetary Affairs, Department of State, and the Security Pacific Bank. Figures are derived from percentages.

The impact of debt rescheduling

According to the Department of the Treasury, the United States has provided approximately $2.3 billion in debt relief since 1973. (See table below.) However, government officials have observed that on some concessionary loans the real value of the repayments decreases with inflation and the rescheduled loans may become, in effect, grants over time.

Table 3

Debt Relief Provided By the United States

Since 1973

Year	Amount (millions)
1974	$374
1975	$158
1976	$285
1977	$168
1978	$153
1979	$263
1980	$357
1981	$295

Note: Excludes military credits which could represent as much as 20 percent of the amounts shown.

Source: The Department of the Treasury.

Debt rescheduling potentially affects the programs of the creditor agencies whose loans are rescheduled. These agencies may be required to absorb the foregone (i.e., rescheduled) repayments in their program budgets to avoid exceeding congressional budget ceilings.

According to the Treasury Department, the increased number and size of debt reschedulings may affect proposed budget outlays under the international affairs function. Under budget presentation rules, principal repayments on an agency's outstanding loans are netted against disbursements on that agency's new loans and other current outlays for the upcoming fiscal year. A debt rescheduling has the effect of reducing projected receipts, thereby increasing net outlays for the affected agencies and accounts under the international affairs function.

The Treasury Department has stated that debt rescheduling is conceptually an uncontrollable budget outlay. According to a joint Treasury Department and Office of Management and Budget study, it is desirable to prevent these uncontrollable outlays from forcing cuts in other international programs that are

uncontrollable. Under the 1974 Budget Act, the Congress cannot consider a funding proposal that would cause an outlay ceiling for a specific function to be exceeded. If outlay estimates increase (due to debt reschedulings), the appropriations committees may find it necessary to make offsetting reductions in funding for other proposed programs to stay within the budgetary ceiling for the international affairs function.

Non-financial considerations may influence U.S. rescheduling policy

The United States and other Paris Club creditors have repeatedly insisted that a clear distinction be drawn between debt rescheduling, as a means of alleviating the debt service burden, and official development assistance. Although debt relief and development assistance are forms of resource transfer, most officials with whom we spoke reiterated that debt rescheduling should not be used as a vehicle for development assistance. According to the Department of State, debt relief should only be extended in a situation of default or imminent default, which they consider to be a clearly definable point. The Department of State believes some flexibility is necessary in determining when defaults exist but not be so lax that countries request debt rescheduling as additional assistance. Despite these concerns, it appears that nonfinancial considerations can influence the U.S. Government willingness to reschedule as well as the timing and terms of debt rescheduling.

In June 1980, the United States waived the imminent default criteria for the Pakistan rescheduling due to political considerations relating to the Soviet invasion of Afghanistan. Pakistan had been pressing for additional debt relief as aid since 1978. A State Department official told us that although Pakistan was not in imminent default, the determination that Pakistan was in a state of "preemptive default" helped Pakistan take austerity measures earlier by signing an IMF stabilization agreement. This enabled Pakistan to adopt appropriate IMF policy recommendations before the economy collapsed. Some U.S. Government officials expressed concern that "preemptive default" sets a precedent for debt rescheduling without imminent default, in which case debt rescheduling would not be a strictly financial mechanism. One AID official told us that the Pakistan rescheduling amounted to an after-the-fact rationalization for providing more assistance.

A study on debt rescheduling by the Overseas Development Council concluded that the United States, and other creditor nations, have varied the timing and terms of debt rescheduling to favor certain aid recipients. One example cited compared the different rescheduling terms granted to Ghana and Indonesia in 1966. According to the study, the more favorable terms granted to Indonesia showed the ease with which political factors can influence creditor actions. However, most U.S. Government officials with whom we spoke cited exceptions to the strictly

financial approach as positive examples of how debt rescheduling can be made flexible to meet the needs of the U.S. Government.

DEBT RESCHEDULING AND DEVELOPMENT ASSISTANCE

Countries can experience a deterioration in development momentum when balance-of-payments difficulties occur. In our case study countries, development priorities and programs were altered. As their fiscal situations deteriorated, operational budgets shrank, and it became harder to maintain current levels of expenditures on development projects, let alone achieve further growth.

The Congress has also noted that debt problems do affect development and in the International Development and Food Assistance Act of 1978 (Public Law 95-424) directed that U.S. development assistance emphasize the promotion of conditions to enable developing countries to achieve self-sustaining economic growth. The Congress required an annual report, including a "comprehensive and coordinated review of all U.S. policies and programs having a major impact on developing countries, including but not limited to bilateral and multilateral assistance, trade, debt * * *." The report is to include debt; the status of the debt-servicing capacity of each country receiving assistance; all forms of debt relief granted by the United States and the purpose for which it was granted; and a summary of the net aid flow from the United States to such countries, considering the debt relief which the United States granted. However, it appears that debt rescheduling, balance-of-payments difficulties, and the U.S. bilateral assistance program are not always treated as overlapping in the U.S. debt-rescheduling process.

According to an international banking official's testimony before the Senate Subcommittee on International Economic Policy in 1981, debt problems and economic development cannot be separated, and the Government's response to debt crises cannot be divorced from its overall objectives in the developing world. The Treasury Department maintains that a rescheduling is carried out consistent with the country's economic recovery. One Treasury official noted that, whereas a country's balance-of-payments problems can only have an adverse impact on its development, a debt rescheduling can only have a favorable impact. However, various government and private officials as well as observers of the debt rescheduling process have commented that the major short-term goal of debt rescheduling--to maximize repayment to the U.S. Government--may not always be consistent with the development the United States hopes to promote through its bilateral foreign assistance. For example, the emphasis on short-term repayments may make it difficult for the country to maintain its investments in longer-term development projects.

In the course of developing the U.S. position in a debt rescheduling, AID, as one of the U.S. Government creditor

agencies, has the opportunity to comment on the U.S. rescheduling position. We were told that, in some instances, AID tries to provide analysis of the long-term developmental impact of rescheduling. However, two AID officials indicated that the Agency's view on the long-term macroeconomic impact of the pending rescheduling may not be adequately considered as part of the U.S. negotiating position. Other U.S. Government officials stated that the U.S. Government approach is more directly oriented toward repayment rather than establishing the conditions which would enable a country to continue development and enhance longer-term repayment prospects. A Treasury Department official added that when the United States finally agrees to consider a rescheduling, AID may not have adequate time to prepare a macroeconomic impact analysis. In such cases, AID responds only as a creditor agency, despite its development mandate.

We noted that some of AID's country development strategy statements and other documents included a reference to debt reschedulings that had occurred over the past few years. However, we did not find an analysis or discussion of whether, or how, the rescheduling may have affected the country's development program and priorities, nor whether AID's program was affected in any way. AID's country program documents also did not appear to reflect any changes in AID's development assistance approach except for those cases in which the United States provided specific balance-of-payments support such as through the Economic Support Fund.

U.S. policy appears to draw a distinction between debt rescheduling and official development assistance flows. However, there is a precedent for coordinating development assistance flows with the debt rescheduling process. This has occurred at aid consortia reschedulings, which, in some cases, differ from Paris Club reschedulings in that the donor countries have coordinated aid flows to the debtor nations with the rescheduling process. Although multilateral development bank loans have not been rescheduled, these aid consortia reschedulings have most often been chaired by the World Bank. According to IMF, although the principal framework is the same as at the Paris Club, the emphasis in these reschedulings has been on sustaining resource transfers to the rescheduling country to enable it to carry out its economic development program.

The United States participated in aid consortia reschedulings for India and Pakistan from 1968 to 1974. At that time, the U.S. Government acknowledged that such reschedulings were a substitute for new and additional development assistance. However, many officials with whom we spoke reiterated that debt rescheduling should not be used as a vehicle for development aid.

Various U.S. Government and international financial officials have underlined the need to weigh and integrate the long-term impact of debt rescheduling and U.S. development programs. Some of these discussions have centered on the "short leash approach," under which only 1 year's worth of debt is rescheduled. Generally, debt rescheduling is granted for 1 year at a time so that creditors can better monitor the country's adherence to the IMF stabilization program. In 1981 testimony before the Senate Subcommittee on International Economic Policy, a private banker with extensive involvement in debt rescheduling stated that by granting debt relief for extremely short periods of time, the U.S. Government is keeping debtors on a short leash and thereby contributing to a tight foreign exchange situation which allows little opportunity for new investments. He further stated that the U.S. Government, like private creditors, attaches too much importance to the immediate resumption of debt service payments rather than restoring a financial balance supportive of growth and development.

The Overseas Development Council study took a similar view and termed the short-leash approach adopted by creditors inefficient and costly. According to the study, problems with this type of approach are illustrated by the needs of several countries for repeat reschedulings within several years as well as by the need to reschedule previously rescheduled debt. An Export-Import Bank official told us that when the rescheduling encompasses previously rescheduled debt, this may indicate that the previous rescheduling was a failure. The Development Council study concluded that the reasons for the above trends in repeat rescheduling bear further examination and may indicate the consolidation periods are too short or repayment terms were unrealistic in respect to the rescheduling country's balance-of-payments situation. According to a 1982 study on international lending by the Group of Thirty, 1/ the short-term interests of the creditors may set in place conditions likely to result in more problems later. According to the 1981 Senate Subcommittee testimony cited above, debt reschedulings need to be viewed in a medium-term development context, and not simply to address a short-term ability to repay. Such an approach could enhance prospects for maintained development and, thus, in the longer term, maximize prospects for repayment to the United States.

Retroactive terms adjustment

Developing nations have long pressed the developed countries to adopt the policy of providing generalized debt forgiveness. One form is commonly referred to as a retroactive terms adjustment. Under retroactive terms adjustment, outstanding concessional loans are converted to grants. In March 1978, at the United Nations Conference on Trade and Development, the United States agreed to seek to adopt such a policy.

1/The Group of Thirty is a study group composed of private and public international bankers.

The Congress amended the Foreign Assistance Act in 1978 to include Section 124(c) which authorizes retroactive terms adjustment for the 30 poorest nations. However, to date, no funds have been appropriated for Section 124(c). We were told that the administration stopped requesting funds for retroactive terms adjustments, believing that approval of such funds would mean less funding for new aid. Several AID officials told us that development assistance recipients prefer new aid. Another consideration, they said, is that in a time of domestic program cutbacks, justifying appropriations for debt forgiveness would be difficult.

According to a State Department official familiar with recent debt reschedulings, although the 30 poorest nations may have balance-of-payments problems, these are not the nations most often rescheduling in recent years. For example, in the 3 years 1979 through 1981, 15 countries rescheduled. Only five of these, Madagascar, Central African Republic, Pakistan, Sierra Leone, and Zaire, are in the group of 30 poorest nations. 1/ Thus, the retroactive terms adjustment provision would have potentially affected only about one-third of the nations which rescheduled during this period.

CONCLUSIONS

Debt rescheduling is a unique financial process enabling the United States to respond expeditiously to balance-of-payments crises. The current process has effectively served U.S. interests, however, it appears that if global economic conditions do not improve sufficiently, the 1980s could witness further increases in the frequency and magnitude of reschedulings, as well as an increase in the number of repeat reschedulings. These trends may indicate that the financial and programmatic costs of rescheduling will increase and merit further attention.

The emphasis in U.S. debt rescheduling policy is on maintaining a strictly financial approach to balance-of-payments crises to maximize repayment to the United States. However, non-financial considerations appear to have in some recent cases influenced U.S. Government willingness to reschedule, as well as the timing and terms of debt rescheduling. These departures from U.S. policy have been justified by the economic and political difficulties confronting the rescheduling nations.

U.S. debt rescheduling is intended to be consistent with a debtor country's economic recovery, and is generally tied to the adoption of an IMF economic stabilization program. Debt rescheduling is considered to be a financial matter, but its goals are, to some extent, compatible with the goals of development assistance. The criticisms of the debt rescheduling process tend to center on the proposition that the short-term goal of debt rescheduling--maximizing repayment--may not be consistent

1/Based on the World Bank, World Development Report, 1981.

with the development the United States wishes to promote through its bilateral development assistance program. The U.S. agencies involved in debt rescheduling generally respond to this point by citing congressional intent that debt rescheduling not be granted as a form of development assistance. Even though debt rescheduling is not to be used as a form of development assistance, the rescheduling does, in effect, provide U.S. resources to the rescheduling country as does the U.S. development assistance program. Thus, from the perspective of managing U.S. resources, in both debt rescheduling and development assistance, improved economic conditons and eventual growth are key ingredients in a country's ability to live up to its rescheduling agreement.

Agency comments and our evaluation

We received comments from the Departments of State and the Treasury and AID concerning the proposal in the draft report that the three agencies provide for greater integration of debt rescheduling with the U.S. bilateral development assistance program in a country being rescheduled thus enhancing the objectives of both programs. The three agencies expressed concern that such a proposal tends to equate debt rescheduling with development assistance. They believe this could adversely affect the official U.S. position at the Paris Club, namely that debt rescheduling is strictly a financial matter. They also see this as a departure from congressional intent on debt rescheduling. As a result of their comments we modified our report, by stopping short of a recommendaton.

In its comments AID also pointed out that U.S. debt policy places primary emphasis on a strict financial approach with little consideration given to longer-term development prospects or the developmental implications of alternative debt rescheduling packages. This approach they feel is consistent with Congress' desire to maintain full control over monies used for foreign economic assistance purposes. AID also added that there may be merit in taking a long-term view of the debt rescheduling exercise--2 years versus 1--but cautions that such an approach may be viewed as an effort to use debt rescheduling as a means of providing development assistance.

The Department of the Treasury suggested that, had we considered the financial crises in Argentina, Brazil, and Mexico in our study, we may have arrived at different conclusions. We agree. However, we selected our case study countries on the basis of their receiving U.S. development assistance and being more closely representative of the majority of middle-income countries.

The Department of the Treasury questioned whether the "widespread debt-servicing difficulties are a new and enduring feature of the international financial system." We do not

believe these difficulties need to be a permanent feature of the international financial system to be a significant problem today.

The Department of State suggested that, in those instances when the U.S. Government believes that a nation's balance-of-payments problems jeopardize its development goals, an appropriate response might be to request additional assistance from Congress for development purposes. We agree that such an option can be appropriate and note that it has been exercised.

A GENERAL OVERVIEW OF THE BALANCE-OF-PAYMENTS PROBLEMS IN THE CASE STUDY COUNTRIES

The term "balance-of-payments crisis" is used to describe a number of situations in which a country is no longer able to meet its foreign exchange obligations. Differing sets of underlying factors can generate this condition. Additionally, the evolution of the crisis will vary from country to country. In some cases the balance-of-payments difficulties can evolve into a broadbased economic crisis with long-range consequences for the country's economic strength. The balance-of-payments crises in our three case study countries--Costa Rica, Peru, and the Dominican Republic--had common underlying factors as well as factors unique to each country. Likewise, similarities and differences marked the evolution of the crises in the three countries. We describe some of the more significant common elements in the three countries, particularly the effects of their import substitution policies, one of the underlying factors. We have not attempted to weigh the relative importance of the underlying factors affecting each country beyond noting that they were perceived as significant.

Recent history in Latin America has witnessed balance-of-payments problems generated out of the following four basic situations, singularly or in combination.

--Short-to-medium-term cyclical problems. The pattern occurs when a sudden drop in export earnings due to a particular commodity cycle catches an economy in an expansionary phase including growing imports and, very likely, increased international borrowing. There is a resulting drop in the country's international reserves as both public and private sectors are slow to adjust to the new circumstances.

--Short-term demand management failure. Government fiscal and monetary policies produce an excessive expansion of the economy. The result is rapidly expanding imports which leads to a marked deterioration in international reserves.

--Medium-to-long-term structural weakness. An overvalued exchange rate, steady growth in imports, and weak stimulation to export and agricultural sectors mark the latter phases of an import substitution policy. Over time these conditions lead to a chronic drain on a country's balance-of-payments.

--Trade deterioration. Some countries have somewhat inflexible economies related to their adoption of import substitution policies. Additionally, they also have suffered a severe deterioration over time in the prices of their major exports relative to the cost of their major imports. Some countries may be facing this situation due to the 1979 oil price increases and permanent changes in international markets for their major exports.

Different combinations of these basic underlying factors were present in the case study countries. However, observers in all three countries reported their import substitution policies as a significant factor in generating their balance-of-payments problems. Because of the commonality and significance of import substitution-based development to their balance-of-payments crisis--although not necessarily pre-eminent among the underlying factors in any country--this policy was given particular attention as it affected the evolution of the crises in the three countries.

EFFECTS OF DEVELOPMENT STRATEGY IN EVOLUTION OF BALANCE-OF-PAYMENTS CRISES

All three case study countries employed import substitution development during the 1970s. The latter phase of this strategy usually witnesses heavy imports of raw materials and capital goods, inefficient domestic industries producing for internal consumption, and only sluggish growth in non-traditional exports (e.g., manufactured goods). Although serious fiscal problems, specifically large government deficits, played an important role in triggering the actual onset of balance-of-payments problems in the three countries, the advanced phases of import substitution in the three countries predisposed them to an imbalance in their balance-of-payments. Once the countries began to encounter balance-of-payments problems, the characteristics of an import substitution economy acted to narrow each government's manuevering room for heading off a comprehensive economic crisis.

In the case of Peru, even though the government appears to have stabilized the economic situation, the path to recovery has proven difficult. The Peruvian Government taking office in 1980 has had to deal with the heritage of a rigidly structured economy in which import substitution policies were an important component. According to a World Bank report, Peru's long-term task is to restructure its economy to allow the mechanism of the market place to function more effectively. In particular, in contrast to the operation of an import substitution economy, Peru's industries must gear up to compete in world markets. The social, political, and economic costs of such changes are high and even sound government policies may not ensure short-run success.

DEVELOPING COUNTRY VULNERABILITY TO BALANCE-OF-PAYMENTS CRISES

In the 1970s, the case study countries confronted a set of factors which increased demand for foreign exchange while decreasing government ability to adjust the economy to fluctuations in the supply. These factors in the global economic trends of the 1970s--increasing national debt, fluctuating commodity prices, oil price increases, and at the end of the decade, high interest rates, narrowed the study countries' margin for maintaining their balance-of-payments. Domestically, agriculture stagnated and food imports grew. Government policy favored import substitution, which in the latter phases, increased imports of raw materials and capital goods, and deemphasized non-traditional exports. The role of government in the economy expanded or was significant to begin with. Frequent deficits, large-scale domestic public borrowing and, thus, a tendency to monetary expansion and increased imports reinforced the already strong pressures on available foreign exchange. Balance-of-payments problems were a natural outgrowth of this situation.

World trends in the 1970s

World trends in the 1970s for oil prices, interest rates and external debt created increased demands on study countries' foreign exchange at the same time as the export commodities which they depended upon for foreign exchange earnings continued to follow a fluctuating price cycle. The cycle was not new but the diminishing room for maintaining the balance-of-payments in equilibrium made their situation more difficult. One U.S. embassy official in the Dominican Republic remarked that at each peak in the export cycle the country's balance-of-payments appeared slightly weaker than the previous peak. The downward slope of the country's net foreign exchange income meant that eventually even the cyclical peak in export prices would not lead to an accumulation of international reserves.

Costa Rica experienced first hand, the squeeze of rising debt, an increased oil bill, and dropping export prices. Costa Rica's external debt in nominal terms grew by a compounded annual rate of 20 percent in the 1970s. Not surprisingly, Costa Rica's debt service, as a percentage of exports, increased from 10.3 percent in 1973 to 23.4 percent in 1979. In the late 1970s, oil prices increased while the price of coffee, Costa Rica's major export, plummeted. From 1977 to 1979, Costa Rica's oil bill more than doubled while actual volume of oil imports increased by only 28.6 percent. In contrast, coffee exports increased in volume by 34.5 percent but actual revenue dropped by 10.3 percent. Despite extensive energy from domestic renewable resources by 1979, fully 22.6 percent of Costa Rica's exports were needed to meet the country's oil bill, up from 8.7 percent in 1973.

The Dominican Republic's and, in some respects, Peru's experiences have been roughly similar. For instance, the Dominican Republic's ratio of debt service to export earnings has moved from 5.6 percent in 1973 to 14.1 percent in 1979, as total public external debt outstanding has moved from $420 million to $1.53 billion during the same period. Oil imports cost an estimated $450 million in 1980, approximately 45 percent of export revenue. Sugar, one of the Dominican Republic's major export crops, stood at 12-14 cents per pound by early 1982, down from as high as about 37 cents in early 1981.

Side effects mark import substitution policy

In the study countries the import substitution model for development imposed handicaps on the economy, despite success in the early phases of the policy in stimulating industrial growth and creating jobs. Key measures for implementing such a policy are high tariff walls against imports of competing finished products, incentives to encourage capital imports and industrial production and, in some cases, an overvalued currency. These policies can, according to a World Bank analysis of Costa Rica, lead to a rising percentage of the country's imports being raw materials for industrial production. On the export side, both agriculture and export industries must struggle with high-priced domestic inputs, an overvalued currency, and the drain-off of investment to domestically oriented industries. The result has sometimes been that a country's imports increase with only weak stimulation to exports to pay for them.

Costa Rica has employed an import substitution model for development since the early 1960s. The results have included strong growth in the manufacturing sector as it climbed from 14 percent of gross domestic product in 1963 to 22 percent in 1979, and created an additional 58,000 new jobs by 1977. However, U.S. and other officials pointed out that there has also been a cost in the form of distortion in the economy. Consumer goods have dropped to 22 percent of the import bill with the balance consisting of raw materials for industrial production, capital goods, and petroleum products. The manufacturing sector is a net user rather than supplier of foreign exchange. Although the country's chief exports are agricultural, the return on investment in the production of agricultural commodities does not favor agricultural investment as opposed to investment in the manufacturing sector. That is particularly the case for the growing of food crops.

Peru's economy before 1980 followed an import-substitution policy. According to AID documents, between 1970 and 1976, Peru's imports more than doubled in volume due to industrial expansion. By 1975, raw materials and capital goods for industry constituted roughly 54 percent of total imports.

Despite the increase in imports, there was no corresponding expansion of exports to pay the increasing import bill.

Agricultural sector stagnates as countries pursue industrial growth

Food imports often characterized the study countries in the 1970s. The imports became necessary, as undercapitalized agricultural sectors failed to keep up with population growth. Food imports become one more component of the import bill difficult to reduce.

Peru, a traditionally strong net agricultural exporter, provides an example. Mission officials told us Peru's agrarian reform in the early 1970s disrupted the usual land-owning and investment patterns for the agricultural export sector. At the same time, the import substitution policy provided a strong incentive to draw investment into industrial production. Peru's military government shifted resources away from agricultural credit and extension programs and into construction of a few very large irrigation projects. Average annual growth in total agricultural production was 0.7 percent as the population continued to grow at a rate of 2.9 percent annually.

Food prices are a politically sensitive area in Peru as the cost of food makes up a large percentage of the average family's budget. The typical citizen spends 50 percent of his income on food; among the poorest that figure rises to 80 percent. The Peruvian Government used food subsidies in the late 1970s to reduce the effects of rising food costs on the urban workforce. These subsidies have drained the government's resources.

Role of government in the economy

During the 1970s, state enterprises in Costa Rica, the Dominican Republic, and Peru often filled major roles in energy, agriculture, and industry. The governments directly, and through the state enterprises, controlled prices and allocated subsidies to various segments of their population. Events in each country, often outside the control of the government, led to a drop in revenues, and/or an increase in costs. Suddenly, faced with a growing fiscal deficit, the government hesitated to cut back sufficiently on employment, development projects, and/or on the system of subsidies. World Bank and AID documents indicated fiscal deficits in the three countries led to greater public-sector borrowing, resulting in increased imports and, eventually, an imbalance in each country's current account.

The government's role in the Dominican Republic's economy generally fits the above pattern. State enterprise expenditures constitute 14.6 percent of the gross domestic product, including sugar estates which control some 65 percent of the country's sugar production. Price controls exist for both agricultural and manufactured products. Public sector employment roles have

increased from approximately 80,000 to 150,000 employees since 1978. Salaries have doubled as the government attempted to professionalize the civil service. The central government's deficit grew from 0.3 percent of the gross domestic product in 1977 to 6.3 percent in 1979 with an accompanying major expansion of credit to the public sector.

In Peru, during a period of military rule from 1968-80, the number of state enterprises grew from 14 to 124. According to World Bank documents, because the government extended subsidies for food, fuel, electricity, irrigation, and agricultural credit, public enterprises could seldom finance a reasonable part of their own investment program. The drain of sizeable public-sector investment in addition to a central government fiscal deficit after 1974, led to a growing government deficit. The deficit, as a percentage of the gross domestic product, rose from 2.2 percent in 1971 to 9.2 percent in 1977; the year before, Peru signed an IMF agreement and rescheduled its external debt. Excessive credit for the public sector had aggravated a weakening balance-of-payments. By 1977 Peru's net international reserves were a negative $1.1 billion.

FOREIGN EXCHANGE BASED CRISES AFFECT ORGANIZATION OF ECONOMY AND SOCIETY

Balance-of-payments problems in the case study countries resulted in a growing disruption in their economies. Domestic and international credit shortages, structural weaknesses in the economy associated with import substitution, and public sector deficits--all factors which helped to bring on balance-of-payments problems--worsened under the impact of the foreign exchange shortage. The worsening of these problems had widespread effects in the case study economies which, in turn, fed back into the balance-of-payments problems. Traditional tools for dealing with the situation, such as devaluation, reduced public spending and monetary contraction tended, at least in the short run, to throw the economy into recession. Thus, the balance-of-payments problems in the study countries eventually spiraled into a broadbased economic crisis.

Foreign exchange shortages deepen as economy struggles with growing crisis

As the balance-of-payments problems moved towards a crisis, the normal sources of foreign exchange progressively diminished. The international banking community steadily limited credit and potential foreign investors tended to adopt a wait-and-see attitude. Private domestic capital began to take flight. The case study economies could not sufficiently boost exports, and as short-term trade-related credit began to dry up, even normal export earnings were in danger.

As the international banks began to perceive the study countries as having balance-of-payments problems, they started to limit and/or withdraw credit. Although the drying up of credit is progressive, a key point is reached when new credit no longer covers the cost of refinancing old debt. For example, Peru borrowed $500-600 million per year from 1973 to 1975. From 1974 to 1976 it also drew $1.2 billion from its reserves. However, in 1978 the country was able to borrow only about $100 million, with its net reserves gone and immediate payment due of approximately $1 billion in obligations. Likewise, both the Dominican Republic and Costa Rican governments reached points where they could no longer secure major new loans from the international banking community.

With the deepening economic crises, foreign investors and suppliers of domestic capital became increasingly cautious. A major international bank's representative in Peru stated that there was little likelihood of major foreign investment until Peru's economic situation stabilized. In Costa Rica, a private economist predicted little if any investment for a couple of years down the road. Capital flight from Costa Rica was estimated at $200 million in 1980. While local observers in the Dominican Republic reported capital flight, no estimates were available.

The foreign exchange credit squeeze reaches its most dangerous phase when trade-related and supplier credits begin to dry up. At that point, industries dependent on imported raw materials or intermediate goods have to draw down their stocks. Peru, in 1977 and 1978, experienced some withdrawal of short-term credit. We were told there are clear indications of this last phase beginning in the Dominican Republic. A U.S. banker in the Dominican Republic explained that his bank was still making loans repayable in Dominican currency but at this point the bank would be extremely leery of making any loans dependent upon repayment with foreign exchange. Finally, Costa Rica now has only limited short-term credit available even for export-oriented industries. A prominent Costa Rican banker predicted that a sizeable percentage of the private sector would not be able to last out the next year without renewed access to foreign credit.

U.S. and other officials we talked to indicated that the study governments had few options when faced with a growing foreign exchange shortage. As countries pursuing import-substitution policies, their imports were largely non-compressible if domestic production was to be maintained. Additionally, the inward-looking structure of their economies discouraged a rapid shift to exports.

Balance-of-payment difficulties in economies structured for import substitution

The study country economies, structured for import substitution, faced additional handicaps in struggling to

surmount a balance-of-payments crisis. Domestic industry was dependent upon extensive/large imports of raw materials to maintain industrial production. Additionally, the economies were structured to promote production for narrow domestic markets. Thus, at a time that their economies needed to limit imports and rapidly become oriented to new export markets, they were in a position to do neither easily.

The balance-of-payments crises, in acting to limit the supply of foreign exchange, eventually forced a cutback in imports of raw materials and, thus, production. For example, we were told the Dominican Republic has arrived at the point where foreign exchange shortages have cut raw material imports. There are also import controls. In Costa Rica, imports contracted by 29 percent in 1981.

During a balance-of-payments crisis, potential exports must still overcome economic structures geared to the domestic market. Incentives remain heavily weighted to favor investment for domestic production. In Costa Rica, a World Bank study of 16 products found that incentives were such that greater profits could be made on 15 of the 16 products if they were produced for local markets instead of for export. Potential exporters also may have to use costly domestic goods produced from protected, often inefficient, domestic industries. In Peru, a World Bank study indicated that export subsidies do not always sufficiently compensate for the extensive use of domestically produced input. Additionally, the banking system may not be geared to international trade. AID recently helped to finance a bank in Costa Rica that would offer export related services precisely because of the current lack of such services.

Public-sector finances worsen credit shortages

In all three countries, we were told the government faced a rapidly deteriorating fiscal situation as the effects of the balance-of-payments crisis worked its way through the economy. Drops in trade and domestic production eroded the tax base, thereby diminishing government revenues. An initial response to these fiscal problems frequently was to continue to borrow from the domestic banking system to cover the deficits. A side effect of that decision was a steady decrease in the credit available to the private sector. From 1971 to 1973 the Peruvian public sector obtained 45.6 percent of new credit; from 1973 to 1976 its share increased to 62.4 percent. Costa Rica's experience was parallel to Peru's, as its public sector share of new credit rose from 36 percent in 1978 to 64 percent in 1980. Thus growing limitations on domestic credit for the private sector matched the drying up of international credit.

Governments face difficult options

The steps a government can take to try to limit a growing balance-of-payments crisis, such as devaluation, budget cuts,

import controls and monetary contraction can have negative effects for both the general public and the private sector. For example, devaluation, which potentially has several positive effects, can also stimulate inflation.

The import substitution structure of the economy acts as a direct channel, whereby devaluation boosts inflation. Devaluation multiplies the cost of imported raw materials which go into industrial production. Another effect is that private sector debt denominated in foreign currency is suddenly multiplied by the amount of the devaluation. In the case of Costa Rica, where the currency was devalued some 400 percent in relation to the dollar over 3 years, a Costa Rican businessman told us that many firms selling their products for local currency, but with foreign currency denominated debt, had become technically bankrupt. Additionally, import controls also feed inflation as they close off the safety valve for the demand created by large public sector deficits.

The impact of cuts in government spending spread throughout a society. Investment cutbacks slow down the pace of development projects. Reduced operational and maintenance budgets can lead to long-term damage to physical and social infrastructure such as road and communication systems, irrigation works, or service delivery systems. Elimination of subsidies and price controls may lead to more effective resource allocation, but also increase costs for the general public and private sector when both are already struggling with painful adjustment. We were told by U.S. and host-government officials that the IMF agreements with Costa Rica and Peru broke down in part because it was difficult for the governments to impose heavy sacrifices on their societies. Lastly, the central banks in both the Dominican Republic and Peru kept the money supply under tight rein. Both economies experienced significant drops in their gross domestic product, in part, in response to the tight credit.

PERU: AN EXAMPLE OF DIFFICULTY IN RECOVERING

The case of Peru illustrates that serious economic problems can remain even when the balance-of-payments crisis abates. In the aftermath of the crisis, the government still must deal with the economic damage arising from the crisis itself, the underlying structural reforms needed to avert future crises, and popular frustration with a reduced standard of living. This agenda for action includes conflicting demands which must be balanced against each other. The prospect is for a long and difficult transition to full recovery.

Peru has had a difficult time mounting a recovery since its 1978 IMF agreement even though it pursued generally sound policies. In 1978, at the beginning of its recovery process, Peru faced a huge debt service burden, low prices for its major exports, and a stagnant agricultural sector. The country had a

rigid and inefficient economy shaped by an import substitution program, high inflation, a large public sector, and comprehensive government involvement. Mission and other officials indicated this array of problems took place against a set of long standing Peruvian problems--very high unemployment and underemployment, widespread and severe poverty, and a massive backlog of unmet development needs. Illustrative of the depth of Peru's problems was the fact that on a per capita basis the country was no better off in 1978 than it had been in 1969 and 1970.

The democratically elected government taking office in the summer of 1980 had a two-part strategy: to restore economic order to the modern sector and to simultaneously implement development programs to meet the needs of the country's poor for jobs and basic services. Loans from bilateral and multilateral donors were to fund much of the development program and at the same time allow the government to improve its debt profile. The government's program for the economy's modern sector, such as commercial agriculture and light industry, was meant to (1) reduce the state's role in the economy through selling off or dismantling all but a core of the state's enterprises; (2) open up the economy through steadily reducing tariffs and eliminating licensing requirements; and (3) create a market-directed economy through elimination of subsidies and price controls.

We were told a combination of good luck and appropriate policies has meant some success for the government's program. Commodity prices for Peru's major exports were high in 1979 and 1980. This brought in unanticipated foreign exchange and tax revenues. A strong program to revitalize extension and credit services to commercial agriculture has already resulted in increased agricultural production. Finally, the World Bank, IDB, the United States, and West Germany have made strong responses to Peru's call for development assistance. Yet by 1982, Peru's strategy had not produced the expected benefits.

The Peruvian Government has yet to resolve problems stemming from some of the previous government's policies, the aftermath of the balance-of-payments crisis, and the international economic environment. Worldwide economic trends by 1982 included recession in the industrialized countries and rising interest rates for new commercial debt. Resulting weak international markets for Peru's mineral and oil exports and the high cost of borrowing deprived Peru of an estimated $1 billion in foreign exchange. Lowering tariffs and eliminating other protective practices led to a boom in imports but inflation dropped only slightly and a substantial drain on the country's foreign exchange reserves occurred. Peruvian business struggled to survive in the new environment. Domestic investment failed

to take full advantage of the more open economy. Likewise, foreign investment, except for oil exploration was timid. We were also told that the private sector did not jump at the opportunity to buy any of the public sector enterprises up for sale.

The government plan to alter its debt profile ran up against several key problems. Donors reported that government services weakened by years of low salaries, did not have the manpower or technical expertise to rapidly develop a portfolio of projects for immediate donor financing. Those projects already underway faced frequent delays because of Peruvian problems in meeting counterpart funding requirements.

The recommended policies for Peru are largely in place but progress continues to be slow. In May 1982, the Peruvian Government, faced with a continuing drain on its international reserves, signed an IMF standby agreement. According to a U.S. bank representative in Peru, the agreement will effectively mandate a contraction of public and private credit which, at best, can only lead to slow growth and even less reason for foreign and domestic investors to make the commitment which could spark a new pattern of growth in the Peruvian economy.

AID'S PROGRAM IN THREE LATIN AMERICAN COUNTRIES

Our three case study countries, Costa Rica, Peru, and the Dominican Republic, are experiencing different stages of economic difficulty and appear to illustrate, in varying degrees, the kinds of problems AID officials indicated can affect middle-income countries. Below, we examine AID's program in each of the three countries.

Costa Rica

Costa Rica, presently experiencing a severe economic crisis, has traditionally been an example of democracy at work, demonstrating that an open society and free market economy can achieve stable growth while spreading the benefits of growth widely. Costa Rica's stability is being threatened now by the spread of economic and political turmoil in neighboring countries to the north as well as its own internal economic disorder. This is AID's description of the situation in Costa Rica. In the AID mission's view, Costa Rica's deep economic crisis is jeopardizing its ability to continue development while maintaining democracy. Mission officials believe that a long period of stringent financial and fiscal discipline will be required and that the economy must undergo a difficult and far-reaching structural adjustment. U.S. interest in Costa Rica is to assist it in carrying out the required discipline and adjustment in a manner which preserves the basic tenets of a democratic society and a free market economy.

AID has shifted the primary focus of its assistance from long-range development to urgent measures to deal with the crisis. Major mission objectives are (1) in the immediate term, to help stabilize the Costa Rican economy, and (2) in the medium- to long-term, to help increase industrial and agricultural production with particular emphasis on export promotion. To accomplish this the mission has proposed a package of Development Assistance, Economic Support Fund, Public Law 480, and Housing Investment Guarantees. The following table shows actual AID resource flows for fiscal year 1981 and projected flows for fiscal years 1982 and 1983.

Table 1
Resource Flows
($ thousands)

Program	FY 1981 (Actual)	FY 1982 (Estimated)	FY 1983 (Proposed)
AID 1/			
Loans	2,619	30,553	76,821
Grants	892	2,986	3,216
Total AID	3,511	33,539	80,037
Public Law 480 2/			
Title I	0	18,000	10,000
Title II	1,814	309	0
Total Public Law 480	1,814	18,309	10,000
Total AID and Public Law 480	5,325	51,848	90,037

1/AID levels represent actual and estimated expenditures.
2/Public Law 480 levels represent actual and estimated value of shipments.

Source: AID fiscal year 1983 congressional presentation.

AID's Development Assistance program includes assistance to Costa Rica's social security agency serving the poor to streamline its management and financial operations and programs. The program will also continue to address Costa Rica's need for efficient energy production, urban improvement and employment, expanded technological and scientific capability, and natural resources conservation.

The AID totals shown in the table for fiscal years 1982 and 1983 include balance-of-payments support under the Economic Support Fund in the amounts of $20 million and $60 million, respectively. These funds will finance mainly imports of goods, machinery, raw materials and technical assistance necessary to help spur production, employment, and exports in agriculture and industry. The Public Law 480, Title I program will finance essential food imports, thereby, serving to also directly reduce balance-of-payments pressures.

The mission has consolidated some of the development projects begun before the present crisis and is emphasizing more rapid disbursement on existing loans to help the immediate balance-of-payments. The latter appears to have been, so far, difficult to accomplish. We noted some concern by both mission and Costa Rican officials that some project activities can move only so fast and the effort to "get the money out" could jeopardize project goals. A similar caution was voiced on new

projects. Although AID may have the ability to put new projects together in a short time, the emphasis on rapid disbursement could come at the cost of giving adequate attention to priority development needs.

Under current circumstances, Costa Rica is unable to provide large counterpart financing for development projects. Accordingly, the mission has renegotiated existing loans to decrease the counterpart requirements from the previous 50 percent average requirement to approximately 25 percent. In addition, the United States and Costa Rica have negotiated an agreement whereby the Government of Costa Rica will apply part of the local currency generated by Public Law 480, Title I food sales against Costa Rica's counterpart liabilities on AID projects.

The U.S. program is expected to provide about 25 percent of the projected $400 million in balance-of-payments support the Government of Costa Rica will require in 1982. The U.S. assistance is subject to Costa Rica negotiating an IMF agreement. The U.S. projection includes the funds proposed for Costa Rica under the Caribbean Basin Initiative, a program U.S. embassy and mission officials said was exactly what Costa Rica needed. The rest will come primarily from IMF, the World Bank, IDB, Mexico, and Venezuela. Smaller amounts may come from European, Canadian, and Japanese governments.

Private capital flows, foreign or domestic, are expected to continue holding back until the economy shows definite signs of stability. The Government of Costa Rica ceased payments on its foreign private debt for a period starting in 1981. Discussions between a committee representing foreign bankers and the government are taking place but a debt rescheduling has not yet been negotiated.

Balance-of-payments crises are not new to developing countries. Cyclical downturns in commodity export markets causing such difficulties have been common. Consequently, there is a tendency to view such problems as temporary. However, U.S. and other officials do not view Costa Rica's crisis as just a temporary aberration or another cyclical downturn in its economy. An embassy official said there are still two hopes for a way out of the crisis--an increase in coffee prices, or oil discovery--but either would only delay the economic adjustments Costa Rica will have to make. A World Bank report states that the Costa Rican crisis should not be viewed as simply stemming from a dramatic decline in terms of trade and it is therefore no different from previous crises. According to the report, low coffee prices are a proximate cause of Costa Rica's difficulties but internal policies and developments (see app. I) are also causes.

The present Government of Costa Rica, we were told, recognizes the severity of the crisis and is actively seeking increased international assistance and will likely agree to an IMF stabilization program. The previous government failed in trying to implement two such agreements and, we were told, was cool to official development assistance and the policy-related conditions attached. U.S. and other officials said this caused a delay in Costa Rica's recovery.

AID strategy in Costa Rica has now shifted the primary focus of assistance from long-range development to urgent measures to help deal with the crisis. U.S. and other officials acknowledged past development achievements are in danger of being lost. In the mid-1970s, AID was preparing to leave Costa Rica because the country was so much better off than its neighbors. The mission had adapted its strategy to fine tune Costa Rica's development and to attack the remaining pockets of poverty. This led to a portfolio of fairly sophisticated projects including agrarian reform, energy and natural resource planning, banking, and science and technology. AID was able to undertake such projects due to the high level of programing capability in the Government of Costa Rica.

A mission official told us when the crisis came the mission found itself project bound. The Government of Costa Rica had difficulty supporting the portfolio of complex projects and the mission had to change its program and prepare a crisis intervention plan. Mission officials indicated they had, at first, viewed Costa Rica's balance-of-payments difficulties as cyclical rather than structural. Some of the officials now believe Costa Rica may be at a point in the development process at which a country is particularly vulnerable to balance-of-payments difficulties.

The Ambassador noted AID had restructured its program since 1980 and said there is a greater danger in deteriorating balance-of-payments situations if AID projects are not flexible enough to adjust to the situation. The progression of events in Costa Rica illustrates the factors which can affect the flexibility of the missions.

U.S. officials in Costa Rica told us they saw a crisis looming as early as 1979. The mission thought the World Bank and IDB should be the ones to take the lead in helping Costa Rica through its difficulty. By 1980 the mission, concluding that assistance from the two multilateral banks was not enough to see Costa Rica through its crisis, informed AID of the increasingly serious economic developments in Costa Rica and requested Economic Support Fund assistance.

The request for Economic Support Fund assistance was not approved at that time. Mission officials acknowledged AID receives many such requests and it takes a very good case to

justify such assistance. One mission official told us AID did not recognize the severity of Costa Rica's situation in 1980.

However, AID officials in Washington visited Costa Rica in connection with the Caribbean Basin Initiative in April 1981. We were told they came with proposals to encourage independent, private-sector activity and found instead the unanimous view that Costa Rica was in such serious financial difficulty that it needed direct U.S. Government financial support. Mission officials stated that it was the serious political problems arising elsewhere in Central America that finally convinced the United States to provide substantial balance-of-payments support assistance to Costa Rica. Thus, it took a political as well as economic crisis to enable AID to mount what is now a rescue effort. Both U.S. embassy and mission officials said that the United States has now taken the lead in encouraging other official donors to increase their assistance to Costa Rica.

Peru

Peru went through a severe balance-of-payments crisis and rescheduled its debt in 1978. A rise in export earnings brought a more rapid recovery than expected. By 1981, however, declining export prices and worldwide recession once again brought serious balance-of-payments problems. The present democratically elected government replaced a military government in July 1980. According to the mission, the new government's policy provides a solid framework for overcoming short-term difficulties and achieving long-run equitable, market-oriented economic growth.

Despite government achievements to date and favorable policies, Peru continues to face a difficult economic environment including high inflation, a fragile balance-of-payments situation and high rates of unemployment and underemployment. Long-run problems confronting Peru include basic development problems such as widespread poverty, rapid population growth and rural-to-urban migration, poor health and nutritional conditions, and agricultural production lagging behind population growth.

The mission's overall assistance strategy is to help the Government of Peru to deal with development needs--in particular, persistent poverty--and yet enforce strict budgetary austerity over the next several years. According to the mission, policy directions taken by the government reflect a high priority for development and a determination to pursue market-oriented economic growth which is consistent with U.S. foreign assistance objectives. The mission believes the U.S. assistance program plays a key role in supporting these political and economic objectives.

The following table shows actual AID resource flows for fiscal year 1981 and projected flows for fiscal years 1982 and 1983.

Table 2
Resource Flows
($ thousands)

Program	FY 1981 (Actual)	FY 1982 (Estimated)	FY 1983 (Proposed)
AID 1/			
Loans	17,523	31,319	22,926
Grants	3,434	8,254	9,751
Total AID	20,957	39,573	32,677
Public Law 480 2/			
Title I	20,000	17,000	20,000
Title II	23,473	18,132	16,038
Total Public Law 480	43,473	35,132	36,038
Total AID and Public Law 480	64,430	74,705	68,715

1/AID levels represent actual and estimated expenditures.
2/Public Law 480 levels represent actual and estimated value of shipments.

Source: AID fiscal year 1983 congressional presentation.

The AID resources provide the government some budgetary support but the program remains basically a traditional development assistance program. AID strategy focuses on three main targets: sierra and high jungle 1/ economic growth, sierra and high jungle social programs, and urban basic human needs. The majority of Peru's poor live in the sierra and high jungle. AID's economic objective is to increase incomes and employment opportunities for the rural poor by stimulating agricultural production, agro-industry development, and improved marketing. Under social programs AID supports low-cost health, family planning, education and nutrition services for the 6 million rural inhabitants of the poorest highland communities. To address urban basic human needs, AID is using the Housing Investment Guarantee program to provide urban poor with basic shelter and services including potable water, sewerage and electrical connections as well as further assistance through community self-help efforts and expanded social programs. The Public Law 480, Title II food aid program is providing food to both the rural and urban poor.

Public Law 480, Title I resources lend budget support by generating counterpart funding to satisfy some of the AID program counterpart requirements. AID officials said other

1/The desert coastal, sierra and high jungle are the three major geographical regions of Peru.

balance-of-payments support aspects of the U.S. assistance program are the housing guarantee program and an emphasis on maintaining substantial grant levels on selected projects.

According to mission program officials, they have not experienced any unusual difficulty in counterpart funds flow on their projects. This was a marked contrast to other donors we contacted for whom counterpart funds flow had become a serious problem. Missions officials believe the local currency generated through Public Law 480, Title I food sales plays an important role in providing counterpart funds and in assisting the government through a serious budgetary crisis.

The mission and embassy economic officers view the Peruvian economy as complex and resilient enough to weather the current budgetary and inflation difficulties, provided the international recession abates. Furthermore, the magnitude of assistance necessary to carry Peru through a crisis of imminent default would likely be greater than the assistance a single donor could provide.

In recent years, Peru has received approximately $250 to $300 million annually in foreign assistance. This amount is expected to increase to approximately $500 million per year, primarily due to increases in the World Bank and IDB programs. The United States and West Germany are expected to continue to be the leading bilateral donors. Assistance under the IMF agreement signed in June 1982 will amount to approximately $1 billion over the next 3 years. As Peru's assistance needs increase, the proportion provided by the United States can be expected to decrease, short of an emergency effort such as that currently proposed for Costa Rica.

Foreign and domestic private investment declined under Peru's previous military government. According to private business and government officials, it has not increased significantly despite the present government's efforts to attract such investment. Government incentive measures have increased the interest of potential investors in helping Peru develop its resources, especially petroleum and minerals. However, we were told, there is a general "wait and see" attitude especially in manufacturing for the domestic market.

U.S. and other officials in Peru told us it would take several years for Peru to resolve its balance-of-payments problems. They said even though the Government of Peru was already taking the appropriate actions there could be further deterioration. Some mission officials said they believe it would take a political crisis similar to that in Central America to get additional assistance approved for Peru.

Dominican Republic

The Dominican Republic is experiencing a serious balance-of-payments deficit and, according to AID and the World Bank, internal economic dislocations, caused mainly by lower commodity export prices and rising imported petroleum costs. A new democratically elected government took office in August 1982, which marked only the second such peaceful transfer of government in Dominican history. Major U.S. objectives in the Dominican Republic are to encourage democracy and increased economic and social welfare.

AID describes the Dominican Republic as possessing a modest range of natural resources, but facing a variety of constraints to accelerated and equitable development, including (1) a depreciating physical resource base; (2) low food production; (3) high and growing unemployment and underemployment; (4) a diminishing, but still high, population growth rate; (5) shortages of skilled workers; and (6) a continuing dependency on sugar as the chief foreign exchange earner. These long-standing problems have been exacerbated by the balance-of-payments pressures.

The following table shows actual resource flows for fiscal year 1981 and projected flows for fiscal years 1982 and 1983.

Table 3
Resource Flows
($ thousands)

Program	FY 1981 (Actual)	FY 1982 (Estimated)	FY 1983 (Proposed)
AID 1/			
Loans	9,897	18,124	16,413
Grants	3,678	6,463	4,432
Total AID	13,575	24,587	20,845
Public Law 480 2/			
Title I	15,000	17,000	18,000
Title II	4,356	3,522	2,783
Total Public Law 480	19,356	20,522	20,783
Total AID and Public Law 480	32,931	45,109	41,628

1/AID levels represent actual and estimated expenditures.
2/Public Law 480 levels represent actual and estimated value of shipments.

Source: AID fiscal year 1983 congressional presentation.

The previous government, which took office in August 1978, focused on rural development and meeting basic human needs, earmarking about one-third of the central budget for the latter. But given the serious balance-of-payments problems, the mission believes the new government may have to choose whether to continue emphasizing social programs with high continuing costs or to emphasize long-range development activities such as increased agricultural and other productivity.

The mission emphasizes the latter in its program. As in Peru, the AID program provides the government some budget support but remains basically a traditional development assistance program. The program includes projects addressing agricultural productivity, natural resource management, employment generation, energy planning, low-cost health service delivery, family planning, and primary education.

Mission officials told us that, so far, they have not noticed any counterpart fund arrearages beyond the normal delays that always occur. It has, however, taken a greater amount of representation to the government by U.S. officials to insure the counterpart payments remain timely. Other donors were having much greater difficulty in obtaining counterpart funds. One donor representative said the problem has become acute. The mission has taken a measure to help the Dominican Republic meet its counterpart fund requirements and, at the same time, achieve a partial insulation for its program from the government's financial difficulties. AID has negotiated an agreement, on a one-time basis, which requires the government to utilize part of the Public Law 480 generated local currency as counterpart funds for selected AID projects in fiscal year 1982.

In our discussions, a combination of government and some business and banking representatives sounded warnings of a very serious balance-of-payments situation developing. However, some mission officials downplayed the problems and said sugar prices would go up eventually and turn the situation around. Thus, they appeared to view the balance-of-payments difficulties as simply a low in the normal cycle of high and low export commodity markets. Their attitude was a contrast to that of most others we talked to who generally felt that any market recovery would only provide a respite, while the underlying structural problems remain.

Nevertheless, mission officials stressed to us they had adjusted their program to address balance-of-payments problems by supporting development assistance projects in energy and agriculture, two areas adversely affecting balance-of-payments due to large imports of oil and food. The mission director told us he believes AID's program is the most in tune with the Dominican Republic's needs of any donor's program.

Two other U.S. programs may provide additional balance-of-payments support for the Dominican Republic. A housing investment guarantee program was proposed for the Dominican Republic before the current financial difficulties began. The $15 million program proposed for fiscal year 1983 will provide balance-of-payments support through U.S. Government backed loans for low- to medium-income worker family housing. The Dominican Republic is also one of the countries slated to benefit under the Caribbean Basin Initiative. The country would receive additional assistance--direct balance-of-payments support--through the Economic Support Fund. In its fiscal year 1983 Country Development Strategy Statement, the mission noted that Economic Support Fund assistance would effectively complement the AID Development Assistance program.

Private credit, other than short-term trade related credit, has become difficult to obtain. The central bank has been increasingly delaying payments on international letters of credit. Consequently banks have become very cautious about lending in the Dominican Republic. Private business officials we talked to said confidence would have to be restored in the economy before credit again became available.

Foreign credit

The executive branch has emphasized getting the private sector more involved in development. The view of many development officials, such as those at the World Bank and IMF, is that private capital will continue to have an important role in development in the 1980s, especially since official development assistance has leveled off. We found that U.S. banking and other private business representatives and government officials are generally not very optimistic (1) about increasing or even maintaining private capital flow or (2) that private business investment will increase in countries which are experiencing economic difficulties. In fact, it appears private capital is often the first source to dry up as economic difficulties mount and the last to return as an economy recovers.

Our three case study countries illustrated the problems in maintaining private capital flow. (See app. I.) All three are having difficulty obtaining private credit and the U.S. banking community was not very optimistic about renewed lending as long as the three countries' economic difficulties continue. Furthermore, for Costa Rica and Peru, the economic difficulties have been exacerbated by their large external private debt incurred at high cost.

DEPARTMENT OF STATE
Comptroller
Washington, D.C. 20520

29 NOV 1982

Dear Frank:

I am replying to your letter of October 28, 1982, which forwarded copies of the draft report: "Increasing Balance of Payments Problems in Developing Countries and the Relationship to U.S. Development Efforts."

The enclosed comments on this report were prepared by the Acting Director, Office of Monetary Affairs, in the Bureau of Economic and Business Affairs.

We appreciate having had the opportunity to review and comment on the draft report. If I may be of further assistance, I trust you will let me know.

Sincerely,

Roger

Roger B. Feldman

Enclosure:
As stated.

Mr. Frank C. Conahan,
Director,
International Division,
U.S. General Accounting Office,
Washington, D.C.

GAO DRAFT REPORT: Increasing Balance of Payments Problems in Developing Countries and the Relationship to U.S. Development Efforts

The primary recommendation of the study is for increased coordination among State, Treasury and AID to ensure that debt rescheduling is consistent with U.S. development goals. State Department finds this recommendation unjustified on the following grounds:

A. Misunderstanding of Executive Branch Mandate from Congress.

The GAO report suffers from a fundamental misunderstanding as to the existing financial approach to debt rescheduling. It is the prerogative of the Congress to determine how much funding should be devoted to international development, a decision made in the context of evaluating competing needs for those resources. In appropriating funds Congress must assume that amounts loaned will be repaid according to contracted schedules. It is the responsibility of the Department of State and Treasury to ensure that these programs are administered according to the precepts established by Congress. Thus, debt rescheduling, which is not subject to the appropriations process, is regarded as a tool of debt collection, not development assistance. Much of the above was reported in the body of the study, but seems to have been ignored in formulating the study's conclusions.

If the government believes that a nation's balance of payments situation jeopardized particular development programs or goals, an appropriate response might be to request additional assistance from Congress for development purposes. The existence of a balance of payments problem does not provide sufficient justification for overriding the Administration's mandate to administer existing programs according to the contracted terms.

B. Doubtful Utility of Heightened Coordination.

The study does not indicate how existing programs of terms of debt relief might be affected by such an endeavor. Clearly, AID should have a clear understanding of a country's balance of payments situation in structuring development programs. However, since balance of payments problems and their impact on debt repayment are inherently unpredictable and a substantial body of information is already available from the IMF and Embassy reporting, it is difficult to see what is to be gained by an augmented interagency effort in this regard.

Paul M. McGonagle, Acting Director
Office of Monetary Affairs
Bureau of Economic and Business Affairs

UNITED STATES INTERNATIONAL DEVELOPMENT COOPERATION AGENCY
AGENCY FOR INTERNATIONAL DEVELOPMENT
WASHINGTON D C 20523

December 1, 1982

ASSISTANT
ADMINISTRATOR

MEMORANDUM

TO: Mr. Frank C. Conahan, Director, International Division
General Accounting Office

FROM: AA/PPC, John R. Bolton John R Bolton

SUBJECT: A.I.D. Comments on GAO Study

A.I.D. has reviewed the GAO draft report "Increase in Balance of Payments Problems in Developing Countries and the Relationship to U. S. Development Efforts". We appreciate the effort that went into the preparation of the report and believe that it could serve a useful purpose in calling attention to the existence of severe balance of payments problems in many LDCs. We do not believe, however, that the report provides a clear or adequate justification for the principle recommendations, nor that the implementation of the report's recommendations, that are separately discussed below, would materially contribute to a solution to these problems. Indeed in some circumstances these recommendations could encourage delay in serious undertakings on the part of some LDCs to address these problems.

GAO Recommendation: "That the Administrator, AID, in conjunction with the Secretary of State

-- develop a policy which (1) explicitly provides a framework for taking earlier action in response to potential balance-of-payments problems which may impact on U. S. development projects; and (2) emphasizes possible adjustment in the U. S. assistance program which could assist the country in addressing its balance-of-payments problems."

We recognize the serious balance of payments problems faced by many LDCs, and in specific country situations do provide balance of payments support. This support would normally be undertaken in conjunction with an IMF program aimed at addressing the underlying economic problems which led to the balance of payments situation. As a result our issues with the recommendations are with the timing i.e., earlier actions and adjustments in the U. S. assistance program to provide more balance of payments support. We believe that the existing framework within which the U. S. provides bilateral balance of payments support to LDCs is explicit and generally adequate,

and clearly consistent with the utilization of funds for the purpose for which they were requested by the Administration and appropriated by the Congress.

In our view the recommendation is based on a causal diagnosis of the balance of payments problems of LDCs that does not take adequate account of the extent to which inappropriate economic policies pursued by LDC contribute to the magnitude of their problems. For example the report (page 11) refers to problems faced by COFISA in Costa Rica, but fails to point out that inappropriate macroeconomic policies are largely responsible. Moreover, despite the statement in the report (page 12), that recognizes the IMF as the principle source of official balance of payments support, the recommendation if implemented could affect the critical role that the U. S. Government expects the IMF to play in bringing about the adoption of appropriate economic policies by LDCs.

Specifically we are concerned that the implementation of this recommendation, by providing balance of payments support at an early stage, could serve to encourage LDCs to adopt only partial economic adjustment programs that could well prove inadequate over the medium term to restore sustainable balance of payments situations.

An increased emphasis on balance of payments support by AID as recommended in the report would also result in an unnecessary and undesirable move away from A.I.D's. basic development emphasis. It is A.I.D's. view that the balance of payments adjustment is likely to require both an expanding aggregate domestic supply and a restraining of demand. Clearly as a development organization A.I.D.'s emphasis has been and ought to essentially remain on efforts to increase an LDC's productive capacity. That this is clearly the intent of Congress is reflected in Section 531(a)(1) of the Foreign Assistance Act of 1961, as amended, that requires that to the maximum extent feasible ESF resources, the most relevant of A.I.D.'s funds for balance of payments financing purposes, should be programmed for development purposes. Moreover, given the narrow production base of many LDCs, the predominance of a few primary commodities in their export earnings, and the magnitude of external imbalances that have occurred over the past several years, it will be necessary for LDCs to improve efficiency and diversify the production structure of their economies to meaningfully address their balance of payments problems. A.I.D.'s development programs address these needs. Moreover, in recognition of these same factors the IMF in recent years has more fully integrated efficiency and production oriented measures in its stabilization and adjustment programs.

Consistent with A.I.D.'s desire to increase the efficiency and effectiveness of its development programs, the U. S. country team, of which A.I.D. is a part, attempts to conduct a continuing dialogue with host governments that attempts to focus on potential problems. In the course of such discussions the U. S. presents its views of potential balance of payments problems and how they might be expected to impact on U. S. sponsored development programs. A.I.D. provides advice in appropriate circumstances, but makes clear that it is the host country's responsibility to deal with the problems.

Once a developing country becomes aware of a potential important deterioration in its balance of payments situation we expect the appropriate country officials to make a realistic assessment of whether the country can handle the problem on its own, including through prudent private borrowing, or whether it will need official balance of payments assistance. It is A.I.D.'s policy to encourage developing countries to approach the IMF at an early date. In most cases it would neither be desirable or appropriate to immediately alter the character of on-going U. S. assistance programs to provide direct balance of payments support. Bilateral donor intervention with direct balance of payments support in the initial phase of a deteriorating balance of payments situation may well serve to help the respective country cope with the immediate situation, but may do little to address the underlying causes. Not only does AID seldom have a level of resources available to allocate to a country to achieve needed major changes in the country's macroeconomic policies, but even when bilateral donors, such as A.I.D., act in concert to effect needed policy changes, there is the danger that such efforts might well be viewed as an unacceptable impingement on national sovereignty. Given these factors, A.I.D. accepts the view that the IMF, with support of the MDBs and bilateral donors, is best equipped to effect the macroeconomic policy changes that are critical for the attainment by LDCs of sustainable balance of payments positions over the short to medium-term. A.I.D. is of course aware that balance of payments support may be required in some cases to preserve prospects for future development. In providing such assistance we believe it should be provided within a framework that is compatible with the role of the IMF and consistent with A.I.D.'s development focus.

GAO Recommendation: "That the Secretaries of State and Treasury work with the Administrator, AID:

to provide for greater integration of debt rescheduling with the U. S. bilateral development assistance program in the country being rescheduled by requiring an analysis of

the balance-of-payments crisis, the debt rescheduling, and their impact on the U. S. development assistance program in the rescheduling country and to require such analysis to be part of the U. S. rescheduling negotiating position."

This recommendation appears to be more directed against the strict financial approach incorporated in U. S. debt rescheduling policy, rather than the implementation of that policy. As such, it would appear more appropriate to direct this recommendation to the National Advisory Council on International Monetary and Financial Policies (NAC), the inter-Departmental body charged with formulating and interpreting U. S. debt rescheduling policies. U. S. debt policy places primary emphasis on a strict financial approach i.e., action to reestablish repayments as soon as possible. It does not focus, except indirectly, on longer term development prospects or the developmental implication of alternative debt rescheduling packages. This approach to debt rescheduling reflects the prerogative of the Congress to exercise full control over the allocation of U. S. federal government resources to be used for foreign economic assistance purposes through its appropriation process. Respect of this Congressional prerogative entails the restriction of the use of debt reschedulings to the enhancement of the debt collection process.

The Administration strives, when participating in debt reschedulings, to maintain as clear a distinction as possible between development assistance and debt relief. While there may be merit in taking a longer-term view to the debt rescheduling exercise e.g., 2 years rather than one, more explicitly linking debt relief to U. S. bilateral assistance programs as suggested by the recommendation could easily be viewed as an effort to use debt renegotiations as a means of providing additional development assistance outside the legislative process. The U. S. did agree to "seek to adopt measures to adjust terms of ODA or other equivalent measures as a means of improving the net ODA flows" in the March 1978 Ministerial meeting of the TDB, and later succeeded in getting Congress to enact Section 124(c) of the Foreign Assistance Act (FAA) of 1961, as amended, which provides limited debt relief authorization. However, Congress preserved its prerogative by limiting the debt relief allowed under Section 124(c) to the UN list of least developed countries, and by requiring that such assistance be subject to its annual appropriation process. T

The U. S. considers the renegotiation of debt as an appropriate response only in cases in which it has concluded, on the basis of a detailed analysis of the country's balance of payments situation, that the debtor country faces imminent default. When such a determination has been made the U. S., to enhance

the prospects of comparable treatment with other creditors, attempts to undertake debt renegotiations in the multilateral forum provided by the "Paris Club". A general, but not always exclusive, condition for a "Paris Club" undertaking is that the debtor country negotiate an agreement for IMF balance of payment assistance that includes policy measures, as conditions of the assistance, to address the underlying causes of the economic/financial problems. Thus, the role of debt renegotiation is limited to providing coverage for only the foreign exchange gap that remains after taking account of IMF and other donors assistance. The magnitude of IMF assistance is for the most part determined on the basis of the debtor country's quota and the availability of resources from other sources. While economic development (and growth) implications emerge from this assessment, the approach is basically financial, as is the approach of the "Paris Club".

The introduction of development considerations into the "Paris Club" process could possibly raise problems with regard to equitable burden sharing among official creditors, since each participant official creditor may not have equivalent development interests in each debtor country. Moreover, the inclusion of development considerations may add to the already considerable difficulty that official creditors and LDC government officials experience in obtaining comparable treatment between official and private creditors. This latter group generally can be expected to take a rather strict financial approach to debt reschedulement. In such circumstances there is the potential that official debt reschedulings might be perceived by the Congress as a mechanism that provides a repayment preference for private creditors. Against this background we believe the more appropriate issue is the level of U. S. assistance to the country in such situations.

GAO Recommendation: "That the Administrator, AID, should also:

> require the analysis, regarding the economic impact of the debt rescheduling on AID's development assistance program in the rescheduling country, be made part of AID's economic analysis in its annual budget submission."

We agree that it is desirable to assess the economic impact of debt reschedulings, respectively, on A.I.D.'s development assistance programs in rescheduling countries. In fact, A.I.D. has recently undertaken to substantially strengthen its analytical capacity, particularly in the area of macro-economics, by increasing the number of staff positions for economists. Moreover, A.I.D. missions have been instructed to

directly relate their proposed program and project undertakings to their macroeconomic analysis for respective countries in preparing their country specific development strategies. In addition, A.I.D. also makes use of the macro/micro economic analytical work of the IMF and the IBRD, and has available for its consideration analytical country economic reviews prepared by the Treasury and State Departments. Thus, the analytical undertaking called for in the recommendation has and is continuing to be done and enhanced. As in the past, we plan to include all relevant considerations in our annual budget submissions that are necessary to fully inform the Congress of respective country economic conditions, as well as an assessment of its economic policies within the context of the magnitude of and structure of assistance that we propose.

Clearance:
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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

TY ASSISTANT SECRETARY

DEC 13 1982

Dear Mr. Conahan:

I regret the delay in providing comments before the due date on the GAO's proposed report on "Balance-of-payments Problems in Developing Countries". The delay was due in part to a bunching of work in support of the President's trip to Latin America and to a number of urgent financial and debt problems in that region and in Africa. Also, because we have some basic disagreements with portions of the proposed report, we wished to give ourselves time to consider the report very carefully.

We have provided to your staff, in advance of this formal reply, a copy of the proposed report with comments in the margins. My letter does not repeat these specific comments. Instead, it sets forth our more basic objections to parts of the report and its recommendations.

1. The Broad Perspective. The report notes the unusually large number of debt-rescheduling arrangements involving official creditors that have been concluded in the last two years. It treats this phenomenon as a trend, with the inference that widespread debt-servicing difficulties are a new and enduring feature of the international financial system. We question this view. The current financial problems of developing countries cannot be separated from the extraordinary process of adjustment to disinflation that the world is presently undergoing. Viewed in this context, it would be inappropriate to fundamentally change our approach to balance-of-payments assistance and debt relief in response to some temporary, if serious, dislocations. In particular, it would be useful for your report to place the current LDC debt difficulties in the global context and to highlight the self-correcting mechanisms that are at work and the existing arrangements for coping with debt problems. In addition, the anticipated increase in International Monetary fund resources ɔears mention.

2. The USG Role in Mexico, etc. The financial crises in Argentina, Mexico and Brazil, which all came to a head after you launched your study, are considerably more important in a broad systemic sense than the cases you focus on. The evaluation of those cases might, in the end, suggest different conclusions as to how we should deal with LDC debt problems. A major difference in these cases from most previous ones is that official creditors account for a relatively small share of the external debt. Instead, commercial banks are

the dominant creditors, and the burden of debt relief and new balance of payments financing will fall largely, if not entirely, on them. Nevertheless, the U.S. Government and the governments of other OECD countries are playing crucial roles in helping these three countries overcome their crises. This suggests much greater flexibility on the part of the USG in responding to LDC balance of payments problems than is suggested in the proposed report.

3. Economic Adjustment and the Role of the IMF. There is a short section in the report devoted to the IMF, but this fails to do justice to the role it plays in countries seeking balance of payments assistance and debt relief. I recommend a much more comprehensive treatment of the IMF. In the course of preparing this, you may find that the shortcomings your recommendations are intended to correct have already been addressed - in a satisfactory manner. In particular, such a discussion would highlight the almost universal link between balance of payment problems and inappropriate macroeconomic policies. Since Bretton Woods, it has been the policy of the U.S. Government to place the IMF in the forefront of international efforts to address balance of payment problems. The record of the IMF is a solid one, and this is one reason why debt relief from the USG is so dependent on an IMF arrangement. It also explains the growing importance which the commercial banks attach to a Fund-supported economic adjustment programs in LDC debtor countries. A debt problem cannot be solved with debt relief. The only solution is a new set of economic policies that will bring about a sustainable balance between the debtor country's external payments and receipts.

4. Conflicting Financial and Foreign Policy Objectives. In virtually all difficult debt rescheduling cases, the USG has had to reconcile conflicting financial and foreign policy objectives vis-a-vis the debtor country. Financial objectives have called for reduced levels of U.S. assistance, more stringent debt-relief terms and insistence on strong economic stabilization efforts. In contrast, foreign policy objectives have called for more aid and more generous debt relief because more rapid adjustment by the debtor country carried political risks. This kind of conflict permeates our international relations and requires constant balancing of competing U.S. aims. Even before debt problems arise, conflicting USG objectives create problems and may aggravate incipient debt problems. At the same time, the financial assistance tools, themselves, are deficient. This greatly contributes to the lack of flexibility cited in the report. The question is whether there is a better way to achieve our multiple objectives in these cases.

5. Credits to Uncreditworthy Countries. There are six major foreign assistance programs of the USG: development assistance (AID loans and grants), food aid (USDA/P.L.-480 loans and grants), the Economic Support Fund (State/AID loans and grants), military aid (DOD credits/grants), CCC credits (USDA), and export credits (Eximbank). Each program serves different objectives and has a different terms structure. In our concern about increasing U.S. security, and at fostering U.S. exports of agricultural and industrial goods, we are often tempted to extend credit to countries whose ability to repay is suspect. Our concerns relate especially to CCC credits which are extended by commercial banks on market terms with a CCC guarantee, and FMS military credits which are extended by the Federal Financing Bank with near-commercial interest rates bearing a DOD guarantee. There are generally strong political (Congressional and industry) pressures for extending these loans. Nonetheless, in the case of FMS assistance, the Congress has turned down Administration requests for direct concessional loans. Also, there have been rather stringent limits on PL-480 loans and Congress has been very reluctant to authorize significant amounts of ESF funds on a contingency basis to provide the degree of flexibility needed for extending balance of payments assistance in the event of large or unexpected BOP problems. Thus, the Administration is forced to achieve its foreign policy objectives with instruments that are distinctly second-best from a financial point of view. This is a theme which should be covered in the proposed report because, in a number of cases, credits on inappropriate terms or in excessive amounts have contributed measurably to a recipient country's balance of payments and debt problems.

6. Recommendation on a Policy Framework for Earlier Action. In our view, State and AID have made notable progress in the last two years in tailoring U.S. assistance to the needs of countries experiencing balance of payment difficulties. Two examples are worth mentioning. In the case of Turkey, relatively large ESF loans were extended once the GOT had adopted a solid stabilization program. As the balance of payment strains diminished, the proposed ESF level has been reduced. In the case of Guyana, our assistance levels declined in the face of continuing inaction by the GOG to correct its balance of payments problems. The point is that the Reagan Administration, from the top down, has stressed the link between U.S. assistance levels and the quality of economic policies in the recipient country. The policy environment is being analyzed by USG agencies systematically and continuously, and the conclusions of this analysis are brought to bear on programming decisions in the framework of AID's CDSS reviews and other interagency programming exercises. To an important extent, U.S. bilateral assistance and especially debt relief build on the even more detailed analysis done by

the IMF (see above). Unfortunately, the proposed GAO report fails to describe existing policies and procedures for analyzing economic policies in LDCs fully, and does not identify any specific shortcomings in them. Thus, the implication in the report is that the USG does not adequately analyze the macroeconomic policies of LDCs and that it should give more aid on softer terms to countries experiencing balance of payments difficulties -- apparently without regard to their economic policy performance. We do not believe that this approach is in the interest of the United States, either from a financial or foreign policy point of view, and we believe it would be contrary to the spirit of Congressional mandates relevant to our foreign credit programs.

8. Recommendation on Integrating Debt Rescheduling with Bilateral Assistance. We are puzzled by this recommendation. The report mentions in several places the policy of not using debt relief as a form of "aid", and seems to accept this traditional USG policy (although the basis for the policy is not fully described). Nevertheless, the recommendation seems to suggest that debt relief be provided on more generous terms than can be justified on financial grounds. What is this, if it is not using debt relief as "aid"? We believe such an approach would not lead to resolution of debt problems and that it runs counter to the very strong mandate from Congress we have in this area. The recommendation also calls for "an analysis of the balance of payments crisis, the debt rescheduling, and their impact on the U.S. development assistance programs". I have already mentioned the extensive analysis done by the IMF and the further analysis done by AID and other USG agencies. There is also a careful and separate analysis undertaken in support of the U.S. negotiating position prior to each multilateral debt-rescheduling negotiation in which the USG participates. (A major omission in the proposed GAO report is a description of this last analysis.) With all these analyses already being done, we do not see any benefit to be derived from a call for some "additional analysis". More specifically, we do not see any basis for modifying the debt-relief terms we seek on account of any long-term (project oriented) development assistance concerns, because debt relief is only provided in connection with economic adjustment programs which clearly contribute to the long-term development effort. Also, we do not see any basis for modifying our development assistance (as distinct from BOP and military assistance) program on account of any debt rescheduling concerns.

In closing, I would like to assure you that the Administration's approach to debt relief is neither inflexible nor unsympathetic to the balance of payment problems of developing countries. The best evidence of this at the moment may be the efforts we are making to address Sudan's debt-servicing difficulties. These difficulties are so extreme that extraordinary debt relief from all of Sudan's creditors

will be required during the next year. The USG is taking the lead in identifying a form (possibly quite innovative) of extraordinary debt relief that will provide the relief required in this case without becoming a damaging precedent for further cases. Similarly, but under rather different circumstances, we have responded rapidly and in an innovative manner in other cases, such as Mexico and Brazil.

Sincerely yours,

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Deputy Assistant Secretary
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