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TRANSITIONS IN DEVELOPMENT

The Role of Aid and Commercial Flows

edited by Uma Lele
and Ijaz Nabi

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—*Executive Summary*—

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Uma Lele and Ijaz Nabi

An International Center for Economic Growth Publication

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Preface

Over the past four decades, billions of dollars have been transferred from developed to developing countries. Whether these flows of external capital from donors, lenders, and investors have succeeded in stimulating growth, reducing poverty, and creating human and institutional capacity to carry out the development effort is not always clear and is even, in some cases, a matter of controversy.

Editors Uma Lele and Ijaz Nabi of the World Bank assembled a group of scholars from around the world (all of whom had hands-on experience in development policy) for a conference in Talloires, France, to consider the role of external capital in development. The conference resulted in a book, *Transitions in Development: The Role of Aid and Commercial Flows*, for which this is the executive summary. In eleven case studies on Asian, Latin American, and African countries, these experts show both how aid and other capital flows have worked and how they have failed. Along with four papers on broad, aid-related issues, these country studies offer policy lessons on how aid and commercial flows can best be used to achieve development goals.

Generally, external finance is only a small fraction of capital formation in developing countries, and it complements the national savings and investment effort. Nonetheless, it can make an important contribution to the development process in many countries by transferring technology, strengthening institutions, diversifying investments, opening new development opportunities, supporting appropriate policies, and helping stabilize political situations in rough periods. Steady and predictable flows of aid and commercial capital can be catalysts for advances in growth and human development.

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The book addresses some of the most crucial questions now faced by development economists and policymakers, and it could not have been accomplished without the help of many individuals and organizations. I would particularly like to acknowledge the generous contributions and cooperation of the World Bank, the United States Information Agency, and the Pew Charitable Trust. Their assistance was indispensable in making the study a reality.

Nicolás Ardito-Barletta
General Director
International Center for Economic Growth

February 1991
Panama City, Panama

Summary of Conclusions

In the postwar period substantial amounts of capital, in the form of foreign aid and commercial loans, have been transferred from developed to developing countries, with mixed results. In some cases external capital greatly furthered the development process, and in others, it actually hindered development. *Transitions in Development* examines the roots of the successes and failures of aid and commercial flows to developing countries by looking at the experiences of eleven countries and considering broad, aid-related issues. Editors Uma Lele and Ijaz Nabi argue that stimulating growth and eliminating poverty in the developing world, where nearly 3 billion people reside, have never been more urgent. At the same time, the understanding of the uses of aid and capital flows has never been greater. They have derived lessons for recipients of aid and commercial flows, for official donors, and for private lenders and investors to help them use aid and commercial flows more effectively in the future.

Lessons for recipients:

1. *A large quantity of aid is rarely an important facilitator of development in the absence of a correct policy setting, but small amounts of well-conceived aid can play an important role in assisting governments committed to growth-oriented economic policies.* In countries with a sound long-term growth strategy, manageable fiscal and trade deficits, and few controls on exchange rates and prices, aid and other external financing can help fill

resource gaps faced by developing countries at an early stage of development, given that they typically face gestation lags in reaping benefits from investments. Well-designed external assistance can help improve recipients' capacity to plan policies and prepare and implement projects. It can also help develop the critical physical and human resources that are needed to accelerate the growth rate in the long run but do not yield returns on investment in the short run.

2. *External capital is not a substitute for sound internal fiscal, monetary, and trade policies and domestic resource mobilization.* Persistent fiscal and trade deficits are unsustainable and are strong signals of fundamental instability in the economy. External capital cannot fill constant gaps created by poor domestic policies. Such capital eventually dries up and, in combination with capital flight, leads to debt problems and economic stagnation. External borrowing should therefore be used to complement policies for reducing deficits and increasing domestic resource mobilization, especially since volatile external terms of trade can make debt servicing difficult when countries borrow large amounts of external capital.

3. *For many developing countries, improving macroeconomic management and reforming policy will require painful adjustments in the trade regime and the financial market, the creation of a conducive legal and fiscal climate for private business, and a reduction in subsidies to trim public expenditures.* Such reforms hurt vested interests and test the political will of governments. Aid and external financing can help committed governments institute reforms by providing a temporary cushion to soften the adjustment process.

4. *Outward-oriented policies achieve more rapid growth in gross domestic product (GDP) and employment than*

inward-oriented policies; therefore, external financing that promotes outward-oriented policies facilitates growth more than that in support of import substitution. By promoting exports and containing imports, an outwardly oriented growth strategy tends to ensure efficient allocation of resources. In some cases, external aid has played an important role in helping countries adopt outward-oriented policies. In others, aid taps have been left open regardless of the extent to which distortionary import-substitution policies have been pursued. Experience suggests that developing countries can benefit from an outward orientation even in a situation of protected developed-country markets.

5. *Countries that have done well in overall economic performance are those that succeeded in achieving broad-based growth in their agricultural sector, which employs the bulk of the population at early stages of development.* Agricultural growth was the major instrument for reducing the proportion of the population living in poverty and providing cheap food. In such cases, aid has strengthened agricultural infrastructure, institutions, and technological innovations, which have contributed to agricultural growth and promoted structural transformation from a predominantly agricultural to an industrial economy. This role of aid will continue to be important.

6. *A well-conceived food aid program can ensure that adequate amounts of affordable food are available to poor and vulnerable groups while programs are implemented to increase domestic production.* Since reaping benefits from a broad-based agricultural development program involves long lags, food aid can be an important source of foreign exchange in the interim period. Food aid can, however, create disincentives for domestic food production when given in situations of inappropriate agricultural and rural development policies.

7. *The key to both growth and equity is investment in human capital.* Access to universal primary and secondary education, health care, and water, as well as adequate transport and communications networks, are essential for broad-based participation of the poor in the growth process. By providing technical and financial assistance to strengthen these sectors, aid can make an important contribution in brightening countries' growth prospects and improving equity.

8. *Recipient countries must ensure that aid programs in new areas do not disrupt sound existing programs.* Donors' frequent changes in the focus of aid in response to changing perceptions have been a serious problem. New programs in areas such as women in development represent an increased understanding of the importance of human capital in the development process. The recent emphasis on the environment similarly reflects the multidimensional nature of development. Nonetheless, such programs must be viewed in the context of consistency in external financing.

Lessons for official donors:

1. *In an unfavorable policy regime, characterized by serious distortions and lack of priorities, aid can actually harm a country.* By providing massive capital, donors can cause a phenomenon called Dutch disease, creating disincentives for the production of traded goods and leading to the growth of the nontraded goods sector. In periods of poor policy regimes, donors can exacerbate price distortions and strengthen vested interests in price controls and other inappropriate policies, making both trends difficult to reverse. Aid should be given only when countries are committed to sustainable growth-oriented policies.

2. *Despite the need for appropriate policies, humanitarian aid may be necessary for the least-developed countries even if policies are distorted.* In the least-developed countries, which have substantial policy distortions, large concentrations of poor, and no commitment to reform, extensive aid programs may be suspended but donors must continue to provide humanitarian aid for ethical reasons, as well as to create a conducive climate for future policy dialogue.

3. *Whatever the immediate motives for aid, the long-term development consequences must be kept in view.* Too much aid is given to meet military, political, and commercial objectives of donors, and too little is given for long-term economic growth and development. Greater public accountability regarding uses of aid, as well as more public awareness of aid and development policy issues, in both donor and recipient countries is essential in defining consistent objectives for aid.

4. *Supporting countries committed to policy reform will improve their future access to commercial capital markets, promote growth, and free up aid resources for the less-developed countries.* As more countries realize their economic potential through policy reform, their access to commercial markets will improve, allowing donors to concentrate on those countries where acute poverty will require continued assistance.

5. *Aid programs can help create an environment that enables the private sector in recipient countries to play a leading role in development.* This objective requires donors to work closely with recipient governments to build physical and institutional infrastructure and to raise the quality of the labor force by improving human capital. These steps, along with sound macroeconomic

management, are the vital ingredients in an enabling environment.

6. *The success of aid depends on its stability and predictability.* Donors should exercise constant vigilance to ensure that capital flows are stable. In theory, resources from aid booms, like those from commodity booms, should be saved to be used in adverse circumstances. In practice, however, abruptly turning the aid taps on and off leads to perverse behavior by recipients, who treat aid as a temporary windfall and may go on a spending binge that can actually retard growth.

7. *External financing can encourage the adoption of growth paths that alleviate poverty.* Through policy dialogues tied to the provision of long-term financing and short-term adjustment lending, donors can encourage investment patterns and protect public expenditures that alleviate poverty. Investing in human resources (education and health) in the long run and providing nutritional support to the poor in the short run will promote poverty-reducing growth.

8. *Donors should avoid rapid changes in focus of aid.* Emerging concerns such as the need for macro policy reform, investment in women in development, and the environment should be incorporated into a larger strategy of long-term development and tailored to local cultural and economic conditions. They should not hurriedly replace many worthy ongoing programs; such a move strengthens the perception that they are passing fads. To encourage recipient participation in such new ideas, donors must first create a climate of cooperation through open discussion.

9. *Coordination among donors can result in better aid programs.* Aid coordination can help countries adopt a

sound long-term strategy of development and an effective macroeconomic policy. It can prevent a multiplicity of projects in any one sector and an overburdening of recipients' nascent public administration and promote consistency in policy dialogue. However, care should be taken that donor coordination does not result in collusive behavior designed to dictate the donors' political or strategic agenda, nor should it result in their condoning misguided policies adopted by recipient governments.

10. *Aid tying in bilateral programs can work against the development objective.* Bilateral aid is often "tied" to the condition that recipients buy the equipment and commodities, follow the technical advice, and use the shipping lanes of the donor. Aid tying tends to result in suboptimal use of aid funds by promoting inappropriate technology transfer. It also strengthens self-serving aid lobbies in both donor and recipient countries.

11. *In the long run, sustainable capital and technology transfer from developed to developing countries is best done by promoting trade rather than aid.* Donors can strengthen this process by reducing trade barriers against developing countries and by removing restrictions on the transfer of technology.

Lessons for international private lenders and investors:

1. *In the past, commercial banks lent large amounts of private capital to developing countries without adequate knowledge of the circumstances in which investments were made.* Not surprisingly, private capital has not necessarily been used more efficiently than official assistance. Indeed, in some cases it has contributed to the Dutch disease. Commercial banks need to develop more effective mechanisms for evaluating the long-term macroeconomic, sectoral, and subsectoral effects of their

loans and for monitoring their implementation. Unless commercial banks invest in a better understanding of borrower circumstances, there is a real danger that a debt crisis will recur if lending resumes.

2. *Commercial banks should lessen the huge debt burden facing developing countries to help restore their growth and recover external debt in the long run.* Developing countries with a serious commitment to improve the investment climate have made a good case for debt restructuring to allow for growth. Without additional resources for investment, growth prospects will remain slim and the debt impasse will be perpetuated.

3. *Private investors should sharpen their ability to assess risk in developing countries as a way to bridge the gap between what debtor countries and investors perceive as those countries' economic potential.* It takes two to bridge this credibility gap. While developing countries must do all they can to restructure their economies to improve the investment climate, investors should improve their ability to read economic signals and respond quickly to opportunities. Multinational lending institutions that continually assess the economic prospects and performance of their borrowers can provide the information needed to build investor confidence.

An Overview of *Transitions in Development*

In the four decades following the end of World War II, transfers of international capital provided a large proportion of investment funds for developing countries, but these flows have been extremely volatile. At their peak in 1981, total net capital flows to developing countries reached roughly $137 billion, of which about two-thirds were in the form of private, or commercial, capital and one-third was official development assistance (ODA), or aid. This proportion changed beginning in 1982, however, when Mexico declared a moratorium on its debt repayments, triggering the debt crisis that virtually cut off the highly indebted middle-income countries' access to private capital. By 1988, net flows of private capital had fallen to around $39 billion.

All is not well with aid either. Annual flows of ODA, which benefits primarily poor countries, remained more or less constant at $30–$35 billion in real terms during the 1980s. But this stability belied some important shifts under way since the 1960s. These shifts included the graduation of several countries such as South Korea, Taiwan, Brazil, Chile, Algeria, and Greece out of "major recipient" status through rapid economic growth: a large increase in real ODA flows from Japan, Germany, Italy, the Nordic countries, and the Organization of Petroleum Exporting Countries (OPEC); a large increase in the share of sub-Saharan Africa in total ODA, together with a sharp decline in South Asia's share (excluding Bangladesh); and, not least important, the increased multilateralization of ODA. Underlying many of these changes was the steady decline in the financial share and influence of the United States, the single largest donor until recently.

It is natural to ask, then, how effective these flows of official concessional assistance and commercial capital have been in promoting growth and development in recipient countries. The purpose of the book *Transitions in Development* is to derive lessons from the past about how to channel official and private capital flows in the future to restore growth and alleviate poverty. To derive such lessons, we must consider several questions: How have external capital flows influenced recipients' growth performance and macroeconomic management? Did project and program aid help countries use resources efficiently and develop human capital and institutions? Under what circumstances is food aid beneficial? Can foreign assistance help reduce poverty and improve the access of the poor to social services? What is the significance of stability in aid flows and policy advice in the development process? What role can external assistance play in improving countries' credibility and improving access to private capital markets? Finally, what are the prospects for reduction of debt and resumption of private investment in the debtor countries, and how can external assistance help?

Transitions in Development addresses these questions through case studies of aid and commercial capital flows in eleven countries. These are followed by chapters on multilateral and bilateral aid, food aid, the transition from concessional to commercial borrowing, and new capital instruments for developing countries.

Aid and Commercial Capital Flows in Eleven Countries

India. India has received more concessional financial assistance than any other country, but because of its large population, per capita levels have been no more than $2 annually. Uma Lele and Manmohan Agarwal show that although India's economy has grown more slowly than was expected at independence, the growth rate of per capita income has consistently moved upward in successive decades. India has made significant advances in agriculture, macroeconomic management, industrial and trade liberalization, and poverty alleviation, thanks in part to the financial and technical assistance of aid donors. During much of the 1980s, India exercised conservative economic management, which enabled it to avoid the debt crisis that affected so many other developing countries. Now, in order to maintain growth and alle-

viate poverty at the same time, India must obtain adequate long-term concessional funds and make investment in physical and human infrastructure a high priority, as well as pursue an outward-oriented development strategy.

Pakistan. At independence in 1947 Pakistan was one of the poorest countries in the world. Since then, with an impressive growth rate of 5.3 percent per year over the past four decades, the country has started to climb out of the abject poverty it inherited from the British raj. According to Ijaz Nabi and Naved Hamid, foreign aid played an important role in the pattern of growth that resulted, not only in the volume of resources it made available, but also through its influence on the development strategy Pakistan pursued. Because Pakistan is in a particularly sensitive geopolitical position, aid to the country, especially from the United States, has fluctuated a great deal in response to changing political circumstances. Despite their instability, aid flows have compensated for a low savings rate, and periods of high growth have been stimulated by policy reforms encouraged by donors in periods of high aid receipts. Yet Pakistan has made few improvements in basic health care, population control, and education, which sorely need attention, and the aid partnership has not adequately addressed equity issues.

Thailand. With a reputation as one of the fastest-growing and most successful developing countries, Thailand is in a prime position to become a newly industrializing country. In his chapter on Thailand, Narongchai Akrasanee points out that over the past two decades annual per capita income has grown by a rate ranging from 3.2 to 4 percent. The government has followed a careful development strategy, restricting its own investment to infrastructure, while strongly encouraging private investment. Although Thailand continues to rely on foreign capital, it has strictly limited the level of debt. Foreign aid, mainly from the United States and Japan, has helped establish transportation and communication infrastructures that have benefited the economy as a whole. Agriculture has also become significantly more productive with the help of foreign aid. In recent years, however, commercial loans have become more important in Thailand than concessional

flows. In spite of the country's growth, poverty and social equity issues continue to present problems. Thailand's policy makers see their great challenge as raising domestic savings to overcome the persistent gap between savings and investment.

Sri Lanka. Perhaps the most distinguishing aspect of the Sri Lankan experience is that since 1948 power has alternated between two political parties with very different political philosophies. The pro-growth, market-oriented United National party (UNP) has been supported by Western donors, and the pro-equity, interventionist Sri Lanka Freedom party (SLFP) has received aid from Eastern bloc donors. Thus the nature of government has influenced the sources of aid flows. Sri Lanka has received substantial amounts of aid per capita. Yet, Surjit S. Bhalla concludes in his chapter that the influence of aid donors on the content of policies has probably not been strong. A regime, having decided on a particular course of action, tends to maximize aid flows, and it is at this late stage that aid agencies influence events. He nevertheless argues that in Sri Lanka the policies of the market-oriented UNP have achieved both growth and equity more effectively than those of the SLFP.

Kenya. Kenya is one of the few African countries to have performed well economically. Since independence in 1963, its gross domestic product has tripled in real terms, but has been offset by one of the highest population growth rates in the world. Arthur Hazlewood writes that Kenya has welcomed foreign investment and financial and technical assistance. Bilateral and multilateral aid flows have been large and increasing over time. Aid has increased Kenya's foreign exchange and skilled manpower, stimulated investment, helped improve the road system, and assisted in land transfer and settlement schemes. Aid has, however, often been inefficiently administered, and many projects have been poorly designed and suffered from a lack of infrastructure. High population growth is currently putting pressure on scarce land. Another land transfer scheme, to shift land from large landholders to smallholders, would help alleviate this pressure. As in the past, aid could help finance such a transfer. Aid could also help address the population issue through investment in human capital.

Tanzania. Tanzania has received more aid per capita than most other countries, and its economic growth performance has been among the least successful. Paul Collier looks at how aid and aid donors exacerbated the unsatisfactory economic performance. In the late 1960s President Nyerere launched a commitment to egalitarian objectives by socialist means. From the late 1960s through the mid-1980s, in spite of an aid boom in the 1970s, living standards fell consistently because of a decline in domestic production and unfavorable external terms of trade. A lack of reliable data about economic conditions, however, made it difficult for aid donors to recommend appropriate policies. Donors gave conflicting advice based, in some cases, on institutional rivalries. Collier argues that donors should have warned the Tanzanian government early on against making long-term economic commitments based on the temporary trade-aid boom of the 1970s, and they should have joined together to gather reliable information about the Tanzanian economy that would help them evaluate policies.

Senegal. Claude Freud examines the case of Senegal, one of the most resource-poor countries in Africa. Its economy, based for many years on a single crop—groundnuts—is now faced with seemingly insurmountable structural disequilibria. Per capita income has declined about 20 percent in real terms in the past fifteen years, production throughout the economy is stagnating, and the debt service, which increased tenfold between 1977 and 1986, continues to use up scarce resources. Since its independence from France in 1960, Senegal has remained highly dependent on French aid, and the share of aid in gross domestic product (GDP) has actually increased over time. As a proportion of the national budget, total aid increased from one-third in 1960 to two-thirds in 1985. Until 1968 France paid premium prices for groundnuts, but the end of premium prices led to the decline of groundnut production and the stagnation of the whole economy. Senegal has begun to diversify its exports but has not succeeded in restoring growth. Donors have had little success diversifying the agricultural sector because of low commodity prices. Freud argues that diversification of the economy, a process that can be facilitated by aid, must be an objective for the long term, while the groundnut sector must play an important role in the short and medium term.

Egypt. Egypt's strategic location, large size, and military strength have positioned it at a critical point in the superpower competition. As a result, Heba Handoussa notes in her chapter, Egypt has been one of the largest per capita aid recipients in the world. Aid to Egypt has been characterized, however, by enormous swings in both source (between the East and the West bloc) and amount, because of the changing configurations of superpower politics and the shift in Egypt's foreign policy stance. The large flows of foreign aid have been a mixed blessing. In periods when net inflows were positive, concessionary finance enabled the government to embark on large-scale investments that served the country's long-term development. Given the highly political nature of the aid relationship, however, Egypt has been obliged to play a leading role in the regional military balance, which drains a good part of the state's resources on defense. Domestically, inappropriate macroeconomic policies and wasteful subsidies have contributed to chronic deficits in the budget and balance of payments. As a result Egypt is entering the 1990s with a massive public foreign debt that under present conditions cannot be serviced even under the most optimistic of scenarios. To recover, Egypt will require either debt forgiveness or new inflows of foreign capital into productive sectors.

Mexico. Throughout the 1980s Mexico's economy faltered under a massive foreign debt that all but eliminated the potential for economic growth. The country's economic situation had been quite favorable until the 1970s, when the availability of large amounts of foreign capital led Mexico to borrow heavily, mostly from commercial sources. In his chapter, Francisco Gil Díaz recounts how these large inflows fed the growth of the public sector and financed several unproductive megaprojects. In 1982 the level of debt became dangerously high, and when foreign voluntary lending was interrupted in that year, Mexico entered a protracted economic crisis. The government made several structural adjustments, such as opening the economy to foreign trade, but these have not succeeded in overcoming the crisis. Although aid did make some contributions to social projects, the debt from commercial borrowing has simply become a deadweight to growth. Since the mid-1980s Mexico has embarked on an impressive program of structural adjustment, which is helping to restore confidence in the econ-

omy, bringing down inflation and interest rates, and attracting investment to restore growth.

Colombia. With only limited help from foreign assistance, José Antonio Ocampo shows, Colombia has established a notable record of economic management and growth in the postwar period. Its moderate macroeconomic policies permitted it to grow an average of 4.8 percent a year from 1945 to 1987. Until the mid-1980s, foreign assistance made substantial contributions to Colombia's development. It helped construct a sizable public infrastructure; it provided crucial foreign exchange in the late 1950s and most of the 1960s; it supported the 1967–1974 coffee boom; and it helped build a system of modern economic analysis, planning, and policy making. Moreover, the access to multilateral lending facilitated the transition from U.S. bilateral aid to commercial bank lending in the 1970s. Although Colombia was not immune to the overborrowing tendencies of the late 1970s and early 1980s, it kept its debt levels considerably lower than those in other Latin American countries. Yet Colombia has had difficulty gaining access to private capital markets. If Colombia is to meet its future debt payments, it must obtain new funds.

Brazil. José L. Carvalho traces the record of Brazil and notes that in the postwar period Brazil has for the most part enjoyed a strong record of economic growth. It achieved this growth with large inflows of foreign capital—mostly in the form of direct investment and commercial loans rather than concessional aid—and now faces a serious debt problem. Direct foreign investment—although it was at times restricted because of nationalistic pressures—has helped finance development and transfer technical expertise. Until the mid-1960s loans from multilateral and official institutions were significant, but private loans predominated after the mid-1960s. After the oil price shock of 1973 Brazil relied on import-substitution policies and borrowed abroad to maintain domestic consumption of oil and to sustain a huge government investment program. The second petroleum price shock and the rise of international interest rates in 1979 pushed Brazil into a severe recession in the early 1980s. Since Brazil is only one of the countries affected by the debt crisis, limited foreign aid funds cannot undertake the entire

burden of helping the country out of the crisis. A solution will require a major internal structural adjustment combined with debt rescheduling and some losses to creditors.

Aid-related Issues

The roles of multilateral and bilateral assistance. Over the past several decades, the number of aid agencies and donors has increased, with a change from one dominant donor (the United States) to many donors, and a switch from a dominant bilateral channel (the U.S. Agency for International Development, or USAID) to a dominant multilateral one (the World Bank). As the number of agencies and donors has increased, strong comparative advantages among them have been revealed. Unfortunately, much of the potential benefit from larger aid flows and greater diversity among donors has been lost, principally because of weak leadership, and aid agencies have been overrun by fads in development thinking. A fact frequently overlooked in discussions of aid effectiveness but pointed out by contributors to this study is that as the consensus on development theories shifted, donor advice itself underwent big swings—from import substitution in the 1960s and poverty alleviation in the 1970s, to policy reform and export orientation in the early 1980s, and back to poverty alleviation and environmental concerns in the late 1980s. In their chapter, John W. Mellor and William A. Masters recommend pursuing a global consensus on development that could draw on major economies of scale in providing aid while still meeting the individual needs of each country.

Food aid. Food aid evolved from a means for disposing of food surpluses in donor countries in the 1950s to a policy tool for promoting economic development in recipient countries in the 1980s. Food aid can further the economic growth of developing countries in several ways. First, by maintaining prices of food, food aid augments the domestic availability of food and adds resources for current consumption or accumulation. Second, it provides balance of payments support, just as any other form of foreign aid. Third, to the extent that it is targeted to the poor, it can directly alleviate poverty. Fourth, food aid is often tied to development projects that would not have been under-

taken otherwise. Fifth, to the extent it can be tied to the implementation of growth-promoting policies and reform, it can obviously promote development. Food aid is alleged to create disincentives for domestic food production by reducing prices and encouraging dependency on food imports. Like overall financial aid, food aid may cause—and has caused—disincentives, but it need not. T. N. Srinivasan looks at a number of cases in which food aid can be used to advance consumer welfare. Srinivasan argues that donors and governments can assist the development process by embracing a long-term view of the uses of food aid—particularly in the context of an overall agricultural development strategy.

Although food aid has provided critical foreign exchange and government revenues, it has not played as positive a role in developing agriculture in Africa as it did in Asia. Srinivasan observes that domestic policies are more distorted in the African countries. Moreover, at independence, research systems and human resources were better developed and irrigation possibilities were stronger in Asia than in Africa, allowing for more rapid technical change. To transpose the successful Asian experience to the African countries will require the pursuit of macroeconomic and sectoral policies that do not discriminate against agriculture, together with more thoughtful investment in agricultural support services and human capital.

The transition from concessionary to commercial flows. As they become more economically advanced, countries tend to rely less on official and increasingly on private sources of capital. As Homi Kharas and Hisanobu Shishido show, however, the transition from concessionary to commercial flows is neither smooth nor unidirectional. Commercial borrowing offers many advantages, but only when external capital is demanded in moderate quantities, when it does not replace internally mobilized resources, and when it can be serviced (for example, when terms of trade are favorable to the recipient). Among the most important advantages is the greater degree of independence it offers from the strategic and political factors that affect access to official capital.

In the volatile international economic environment of the 1970s, commercial lending took place in the absence of any of the conditions named above. The independence offered by external private

capital was handled poorly both by recipients such as Brazil and Mexico and by private banks, which made large-scale lending decisions on behalf of their depositors based on inadequate knowledge about the economic circumstances facing the borrowers and about the sectors or projects they were supporting. Official donors, with their greater economic and technical expertise, behaved no differently. The primary goal for both sets of institutions, as well as for the borrowing governments, was to maximize capital flows. In such cases, external capital *did* replace internal savings and led to wasteful megaprojects. Furthermore, commercial banks began to ration credit as the risk of repudiation grew. The unanticipated worsening of external terms of trade and the rise in interest rates only worsened the problems caused by the poor investments.

Not surprisingly, many countries have had to turn once again to official sources of finance. For example, since 1983, Colombia has had to rely on multilateral and bilateral agencies (in addition to private direct investment) for external financing. Poorer countries such as Senegal, where income losses were great, have had to fall back on concessional assistance and adopt the accompanying structural adjustment programs. These programs are intended to curb fiscal deficits and remove government controls to reestablish recipients' creditworthiness as a first step toward regaining access to commercial capital. Thus, as Gil Díaz points out, the debt crisis has prompted both a thorough reexamination of Mexico's development strategy and increased lending from the World Bank and the Inter-American Development Bank, much of which has been in the form of adjustment loans aimed at specific sectors.

Recent developments in the international capital market. In the 1970s, writes John Williamson, middle-income developing countries gained access to international capital markets, but since the debt crisis erupted in 1982, the net resource transfer to developing countries has vanished. Funding arrangements now available to developing countries include debt swaps, equity investment, and interest and currency swaps. It now seems clear, however, that the potential benefits of capital mobility can be realized only if countries time their borrowing and lending correctly. If, like Mexico and Brazil, they borrow when real

resources are relatively abundant and repay when they are scarcer, welfare may be reduced. The most important lesson of the 1970s is that foreign borrowing can be either a curse or a blessing, depending on whether it is used to finance bad policies or to support a well-conceived strategy of intertemporal economic management that pays due recognition to creditworthiness constraints.

Conclusion

The most important factor in development is not the large inflow of external capital, but rather the domestic policies of developing countries. To be effective, therefore, high-quality aid should encourage policy change that leads to growth and poverty alleviation. The evidence presented in *Transitions in Development* shows that small amounts of aid—given in the context of a sound policy environment for the development of physical, human, and institutional infrastructure—are far more effective than large amounts given without attention to the overall development policy. In a correct policy setting, of course, large aid magnitudes would go far toward reducing global poverty and stimulating income growth and international trade.

The importance of stimulating growth and eliminating poverty in developing countries has never been greater. At the same time, the understanding of how to use aid and private capital to achieve those goals has never been more extensive. Sufficient experience has been accumulated to show which countries have successfully institutionalized sound economic management and prudently used domestic and external resources, and which have not. Donor countries now have an unprecedented opportunity to devote both attention and resources to correcting the mistakes of the past and applying the lessons learned. The effectiveness of future flows of external capital will depend on how well the investment decisions of official donors and private lenders reflect these lessons.

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In addition to the contributors to *Transitions in Development*, the following individuals attended the September 1987 conference "Aid, Capital Flows, and Development" in Talloires, France, and participated in discussions of the draft chapters:

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