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Report to the Administrator
Agency for International Development

August 1986

FOREIGN ASSISTANCE

U.S. Use of Conditions to Achieve Economic Reforms

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United States
General Accounting Office
Washington, D.C. 20548

National Security and
International Affairs Division

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August 25, 1986

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

Dear Mr. McPherson:

This report discusses the conditions set by the United States as part of its Economic Support Fund balance-of-payments assistance to Costa Rica, the Dominican Republic, Jamaica, and Liberia, the factors affecting compliance with conditions and whether the recipient countries complied with U.S conditions during the period 1982-85; and whether such compliance can achieve U.S. goals for the countries.

We initiated this review because of continuing congressional interest in the effectiveness of placing conditions on the delivery of economic assistance and their impact on recipient countries. The review builds on and complements prior General Accounting Office studies of economic conditions in developing countries.

We make no recommendations in the report but we caution that the economic conditions and debt-servicing burdens of the countries make it likely that they will continue to need increasing levels of balance-of-payments support in the foreseeable future.

We are sending copies of the report to the Chairmen, Senate Committee on Foreign Relations, House Committee on Foreign Affairs, Senate Subcommittee on Foreign Operations of the Committee on Appropriations, and House Subcommittee on Foreign Operations of the Committee on Appropriations; the Secretaries of State and the Treasury, and the Director of the Office of Management and Budget.

Sincerely yours,

Frank C. Conahan

Frank C. Conahan
Assistant Comptroller General

Executive Summary

Purpose

Economic deterioration in developing countries of strategic interest to the United States has led the Agency for International Development (AID) to link Economic Support Funds used for balance-of-payments assistance to economic policy reforms. The rationale is that policies affecting the allocation, mobilization, and distribution of economic resources are the most important determinants of growth and development, and that without compatible reforms, even large amounts of foreign aid or debt relief cannot succeed in promoting economic and political stability and self-sustaining development. However, the U.S. strategy does not fully address increasing external debt and debt-servicing problems in many recipient countries.

Prior GAO reports have pointed out the need for economic reforms in developing countries and the conditions placed on U.S. assistance to achieve such reforms. This report addresses the following questions for Costa Rica, the Dominican Republic, Jamaica, and Liberia for the period 1982 to 1985.

- What conditions did the United States set for recipient countries?
- What factors affect compliance with conditions and did recipient countries comply with U.S. conditions?
- Can compliance achieve U.S. goals for the countries?

Background

A key problem facing developing countries in instituting economic reforms is how to deal with their external debt-servicing requirements. Developing countries have increasingly sought debt-service relief by undertaking International Monetary Fund (IMF) programs. In return for IMF financing, the Fund requires countries to adopt austerity measures to achieve balance-of-payments adjustment. Fund programs are of critical importance to countries with debt-service and/or persistent balance-of-payments difficulties because foreign debt generally cannot be rescheduled and new commercial loans and trade credits cannot be obtained in the absence of such programs.

Consequently, the United States frequently conditioned its balance-of-payments assistance in recipient countries by requiring them to obtain and/or comply with Fund programs. However, under the Kemp-Kasten amendment to the 1984 foreign assistance supplemental appropriation and 1985 continuing resolution appropriation authority, the Congress restricted the linkage of U.S. assistance with recipient-country compliance with the policies of multilateral institutions, including Fund programs. AID subsequently dropped conditions linked specifically to the Fund.

Results in Brief

United States bilateral conditions have paralleled those of the International Monetary Fund in seeking to stabilize recipient-country economies. The United States has also set conditions directed toward structural adjustment of developing-country economies as well as toward individual country circumstances. Recipient-country compliance with conditions is affected by its political stability, its capacity to expand and diversify its exports, terms of and access to available external financing, and other factors.

Recipient-country compliance has varied as to the timeliness of reforms and the degree to which reforms were implemented.

The U.S. strategy for the countries GAO reviewed has included the rescheduling of external debts and increased borrowing, recipient country adherence to Fund programs, and improvement in each country's export base to service external debt and promote economic development. Each country has high external debt levels and faces potential future debt-servicing problems. AID's export projections to enable the countries to service their debt are predicated upon optimistic assumptions, many of which are beyond the control of the recipient countries.

Principal Findings

An important component for the success of the AID strategy for the economic stabilization of some recipient countries is the rescheduling of external debt. AID economic projections for some countries assume debt reschedulings through 1990, and thus, effective use of U.S. balance-of-payments assistance may be dependent upon an International Monetary Fund program.

The Costa Rican government complied with U.S. conditions due to the high levels of U.S. assistance, the willingness of AID to withhold disbursements for noncompliance, and the government's commitment to reform. The Dominican Republic was initially reluctant to comply with conditions but with increased U.S. assistance and willingness to withhold disbursements, and government recognition of the absolute need for reform, compliance was subsequently achieved.

The Jamaican government was reluctant to undertake reforms, partly because of domestic political considerations. AID consequently revised its conditions and credited the Jamaicans with compliance. The Agency likewise credited the Liberian government's actions as in compliance with U S conditions, but external factors and extrabudgetary expenditures by the Liberian leader offset potential gains from compliance.

The U.S strategy to improve each of these countries' export performance, which would contribute to satisfying debt-servicing requirements and reducing their balance-of-payments assistance needs, is subject to market variables, as well as domestic concerns, and other external factors over which each country has little control Although GAO is not aware of a more promising alternative strategy, GAO does not believe that nontraditional exports can generate the needed foreign exchange within the foreseeable future to compensate for the decline in traditional exports' earnings and provide the solution to these countries' economic growth and debt-servicing problems. GAO cautions that the countries will probably continue to need increasing levels of U.S. balance-of-payments support.

Agency Comments

The Department of State did not provide written comments, but a spokesperson concurred with a draft of GAO's report. The Office of Management and Budget generally concurred with GAO's findings but noted the need for conditionality in the AID program and its support of an export-led growth strategy since the alternative would result in worse economic conditions in the recipient countries

The Agency for International Development also concurred with the broad findings but stressed that (1) the U.S. strategy includes structural reform as well as stabilization, (2) domestic policy errors as well as external factors caused economic problems in the recipient countries, and (3) Jamaica has undertaken important reforms since 1983. AID also stated that its strategy for export-led growth in the countries was not based upon optimistic assumptions, as GAO concluded, and noted that its assumptions have been successfully borne out by the impressive performance of non-traditional exports. Although GAO agrees that export-oriented policies can result in economic growth, it is uncertain that this strategy alone can generate the needed foreign exchange earnings to achieve the U.S goal of stabilizing the countries' debt-servicing problems and promoting self-sustaining economic growth with consequent reductions in U.S. assistance levels.

The Department of the Treasury commented that the draft report's discussion of debt rescheduling was misleading since one could presume that U.S. debt rescheduling policy is predicated upon and subordinate to AID's objectives in recipient countries. The 1978 U.S. policy on debt rescheduling is discussed in chapter 2. GAO does not intend to imply that debt relief decisions are predicated upon or subordinate to AID's country objectives.

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Abbreviations

AID	Agency for International Development
CODESA	Costa Rican Development Corporation
ESF	Economic Support Fund
GDP	Gross domestic product
GAO	General Accounting Office
IMF	International Monetary Fund
OMB	Office of Management and Budget
SAL	Structural adjustment loan

Introduction

Increasing attention is being focused on the need for economic reforms in developing countries and on the conditions and adjustments the United States attaches to its foreign assistance programs requiring recipient countries to undertake such reforms. The goal of U.S. assistance is to promote U.S. security interests, economic and political stability, and self-sustaining growth in developing countries The U.S. strategy in recent years has been to link its bilateral balance-of-payments assistance to economic reforms in recipient countries. The rationale for this strategy is that even large amounts of aid or debt relief cannot succeed in stimulating self-sustaining development if the policy and institutional framework in these countries is not compatible with growth. This report discusses the U.S. attempts to condition assistance on economic reforms in Costa Rica, the Dominican Republic, Jamaica, and Liberia.

U.S. efforts to condition assistance on policy reforms are not new In the early 1960s, the Agency for International Development (AID) attached conditions to its bilateral program loans in such countries as Brazil, Colombia, Chile, India, Korea, and Turkey. AID set explicit conditions requiring a wide range of economic stabilization and growth policies in Latin America. The emphasis in India was on import liberalization and encouragement of private-sector investment, while the conditions for Korea and Turkey were focused on increasing foreign exchange earnings and import liberalization. A 1970 AID evaluation reported that while country performances varied in regard to the emphasis each gave to stabilization, growth, and trade liberalization objectives, each government pursued policies directed toward long-term improvements.

In 1973, the Congress amended the foreign assistance legislation to reorient the purposes and operations of U S bilateral economic assistance The Congress directed that future U.S. bilateral assistance focus on critical problems which affect the lives of the poor majorities: food and nutrition, population planning and health, and education and human resources development. The Congress also directed AID to give highest priority to undertakings submitted by host governments which directly improve the lives of their poorest people and their capacity to participate in the development of their countries This "New Directions" approach, which focused on basic human needs, represented a major change in U.S. development strategy. As a result, AID's programming of assistance no longer focused on conditions directed toward macroeconomic reforms.

Recent Policy Reform Emphasis

After the 1980 presidential election, the U S. approach to foreign assistance was redirected. Partly due to the massive economic problems facing developing countries and the arguable failures of development efforts to promote sustainable economic growth and development, AID adopted four programmatic components which now form the basis for its development strategy: (1) policy reform, (2) institution building, (3) technology transfer, and (4) increased private-sector involvement. Based upon the belief that developing-country policies affecting the allocation, mobilization, and distribution of economic resources most affect growth and development, the United States has been requiring selected governments to undertake economic reforms as a condition for receiving U.S. Economic Support Fund (ESF) assistance.[1]

Cooperation with multilateral and bilateral donors is an important principle which underlies AID's use of conditions. AID uses International Monetary Fund (IMF) and World Bank analyses and studies in performing its own analyses and identifying needed reforms. AID has coordinated its conditions with those of other donors and, in the past, based financial assistance in part on recipient-country compliance with IMF and World Bank programs. However, the Congress' Kemp-Kasten amendment to the 1984 foreign assistance supplemental appropriation and 1985 continuing resolution appropriation authority[2] stated that "none of the funds made available ... shall be restricted for obligation or disbursement solely as a result of the policies of any multilateral institution."

Prior GAO Reports

The following prior GAO reports address economic conditions in developing countries and the need for basic economic reforms:

- U.S. Development Efforts and Balance-of-Payments Problems in Developing Countries (GAO/ID-83-13), February 1983, analyzed the balance-of-payments difficulties in Costa Rica, the Dominican Republic, and Peru. We recommended that AID develop an action plan when a country's payments situation adversely affects AID's development efforts. The plan would include an assessment of (1) whether AID's on-going projects are

[1] ESF is economic aid to promote economic or political stability in areas where the United States has special security or other interests It may be provided in project form aimed at specific activities or as cash transfers which provide untied dollars (i e , for balance-of-payments support), or under Commodity Import Programs which finance a portion of specific commodities and equipment

[2] Public Law 98-396, chapter XII (the fiscal year 1984 supplemental appropriation), and Public Law 98-473, section 1 (the fiscal year 1985 continuing resolution appropriation authority), are commonly termed the "Kemp-Kasten amendment " The 1986 continuing resolution appropriation authority, December 19, 1985, Public Law 99-190, section 1, renewed the Kemp-Kasten amendment

appropriate, (2) how AID projects relate to other donor activities, (3) whether countries are following appropriate economic policies, and (4) each country's external resource needs. AID is performing these assessments.

- AID's Assistance to Jamaica (GAO/ID-83-45), April 1983, raised questions about the effectiveness of balance-of-payments assistance provided to Jamaica in 1981 and 1982. We reported that AID had not achieved substantial influence over Jamaican economic policies, and we recommended that AID use its balance-of-payments funds as a tool to influence policy reforms. AID has attempted to use these funds for reforms, but has had limited success.
- Providing Effective Economic Assistance to El Salvador and Honduras: A Formidable Task (GAO/NSIAD-85-82), July 1985, described difficulties AID experienced in influencing the two countries to implement macroeconomic reforms. We recommended and AID and the Department of State agreed to present to Congress a detailed analysis of future economic assistance costs in the absence of Salvadoran and Honduran reforms. We also recommended that the Department of State initiate interagency discussions to reach consensus on the degree to which balance-of-payments assistance will be used to influence economic reforms in the two countries. The Department is holding such interagency discussions.
- The U.S. Economic Assistance Program for Egypt Poses a Management Challenge for AID (GAO/NSIAD-85-109), July 1985, noted that despite the $7.3 billion in ESF assistance the United States has provided the Egyptian government over the past 10 years, most of the progress in strengthening Egypt's economy has been due to other factors. We recognized the difficulties of establishing an effective economic program in the context of a politically sensitive, congressionally mandated program. We recommended that AID perform economic analyses to better assist the Egyptian government in undertaking policy reforms. AID maintained that it was undertaking such economic analyses.

Objectives, Scope, and Methodology

We evaluated the U.S. policy of conditioning balance-of-payments assistance on policy reforms in selected countries during the period 1982-85, focusing on the following questions.

- What were the conditions the United States set for recipient countries?
- What factors affect recipient-country compliance with conditions and did recipient countries comply with U.S. conditions?
- Can such compliance achieve U.S. goals?

To build upon earlier GAO studies, countries chosen for case study were Costa Rica, the Dominican Republic, and Jamaica. Liberia was included at the request of the House Foreign Affairs Subcommittee. Each country receives substantial U.S. balance-of-payments support, is of strategic interest to the United States, has a history of IMF programs upon which AID has partly conditioned its assistance, and is among the first countries where AID began conditioning its assistance.

In Washington, D.C., we met with officials of AID, the Departments of the Treasury and State, the Office of Management and Budget, the U.S. Office at the IMF and the World Bank. We also met with U.S. embassy and AID mission officials in each country; recipient-country officials from the ministries of finance, economics, and/or planning; the presidents of the central banks, and economic advisors to the presidencies where applicable. In addition, we met with IMF resident representatives; World Bank representatives; private-sector businessmen and organizations; and local, nongovernmental economists

We reviewed legislation and studies on the U.S. use of conditions and the linkage between AID and IMF programs, and used previous GAO reports and articles and studies by analysts in and outside the U.S. and recipient-country governments. We also reviewed U.S. government program documents, economic analyses, and bilateral agreements with recipient countries; IMF stand-by arrangements and economic consultation documents; and World Bank analyses and structural adjustment program agreements.

Our review focused on ESF balance-of-payments assistance, which is the principal U.S. mechanism which can carry conditions designed to influence macroeconomic policy reform.

We contracted with Wharton Econometrics Forecasting Associates to build a country economic model on Costa Rica. The model was developed to simulate and measure the impact of U.S.-imposed conditions on such factors as economic growth, inflation, balance-of-payments deficits, investment, per capita consumption, and employment The model was also used to project future debt and debt-service requirements and the impact of external factors and export growth on the economy's performance.

Our work was performed between November 1984 and August 1985 and was conducted in accordance with generally accepted government auditing standards

AID's Purpose in Conditioning Its Balance-Of-Payments Support Assistance

The U.S. administration believes that the policy reforms required in IMF arrangements are often necessary for the ultimate success of U.S. bilateral assistance. In congressional hearings, the AID Administrator said the main purpose of U.S. ESF assistance was to promote economic and political stability but that

> "If we provided massive balance-of-payments assistance without requiring the host-government to take any corrective measures to reduce their balance-of-payments and fiscal deficits, there would be no end to [their] dependence [on the] U.S ..such dependence is much more likely to increase than to diminish as budget deficits expand, exchange rates become increasingly overvalued, and imports increase "

How Developing Countries Got Into Economic Trouble

During the past 4 years a large number of developing countries have had increasing difficulties meeting their international payments requirements due to shortages of foreign exchange Although this problem took on crisis proportions in August 1982 when Mexico unilaterally suspended payments on its public foreign debt, the problem has been in the making for more than a decade. During the past decade, rapid increases in oil prices and accompanying sharp declines in economic activities in industrialized countries tended to reduce demand for exports, soften export prices, and widen the current account deficits of developing countries. Based on the assumptions that oil prices would continue to rise and that inflation would continue at historically high levels with real interest rates[1] remaining low or even negative, developing countries borrowed heavily to finance their deficits, and financial institutions willingly provided sizeable loans at short-term and variable interest rates Nonetheless, policies later adopted by industrial nations in the early 1980s, which brought inflation down, significantly raised real interest rates, spurring a global recession. While high interest rates and heavy foreign borrowing added considerably to the debt-service burden of debtor nations, the global recession and overvalued exchange rates of many developing countries reduced the competitiveness of their exports. As a result, they faced severe economic and financial difficulties

ESF and Setting U.S. Conditions

While ESF is provided within the framework of U.S. political and security interests, its economic rationale is for development of the economy in the aggregate, and as such, its effectiveness depends upon appropriate macroeconomic policies on the part of the recipient government. AID has maintained that "in the provision of ESF there must be an

[1]The real interest rate is the difference between the stated rate and the general inflation rate

overall economic rationale for its use, even as security and political considerations may first dictate ESF as an appropriate instrument." AID administers the program while the Department of State is responsible for allocation, direction, and program justification.[2] The Administrator of AID approves the final conditions to be attached to U.S. assistance

Conditions are generally proposed by the AID mission following consultation with the U.S. embassy and recipient government. Conditions are coordinated within AID, and between AID and the State Department, and discussed with the Treasury and Office of Management and Budget (OMB). According to the Treasury, "balance-of-payments assistance...is fast disbursing aid designed to fill a payments gap, address and hopefully cure the [economic] problems that have created the gap, and set the stage for long-term growth and development."

In November 1981, the AID Administrator cabled the overseas missions that

> " this Administration places a high priority on the development and implementation by the host government of effective and efficient economic policies which promote an open economic system and self-sustaining economic growth.
>
> "Inappropriate subsidies, price and wage controls, prohibitive tariffs, overvalued exchange rates, interest rate ceilings, and similar forms of interference with market solutions are examples of the type of policies and actions which often have curtailed economic performance and typify areas of needed policy reform."

In assessing the need for reform and appropriate conditions to be set, AID uses internal studies and reports, other U.S. agencies' documents, and IMF and World Bank analyses. Recipient governments also occasionally propose conditions.

AID focuses on the following issues in setting its conditions:

- changes in interest rates which may discourage savings and result in the misallocation of scarce credit, or create excessive demand which requires administrative rationing;
- divestiture of state-owned enterprises to encourage private sector initiative and competition, improve efficiency, and thereby lessen demands on public resources;

[2]See GAO report to the Chairman, Committee on Foreign Affairs, House of Representatives, entitled Political and Economic Factors Influencing Economic Support Fund Programs (GAO/ID-83-43), April 18, 1983

- exchange-rate policy reforms to encourage exports, eliminate incentives for smuggling and capital flight, and remove other distortions that allocate resources inefficiently;
- revision of tax structures which inhibit growth;
- promotion of export diversification and expansion, and
- reduction and/or elimination of government subsidies

In commenting on the July 1985 GAO report on El Salvador and Honduras, OMB noted that

"U S economic assistance is more effective when provided in the context of a sound economic program The better the economic policy environment in a recipient country, the greater is the chance that U S foreign aid will be used effectively If aid is provided in an economic environment dominated by government spending and without proper incentives, it will likely only subsidize consumption without contributing to long-term economic growth

"The prime U S aid objective is to help create conditions that will promote self-sustaining growth The key to such growth is sound [developing country] economic policies which provide incentives for work, savings, and investment

"The consequences of postponing economic reform can be as politically destabilizing as withholding aid disbursements [OMB emphasis] Aid without [conditions] may serve only to 'bail-out' a country temporarily, so that when it is finally forced to act, the necessary reforms require radical adjustment "

A major U.S. response to developing countries' economic problems was to increase the use of ESF assistance for balance-of-payments support and to condition this assistance on recipient countries undertaking economic reforms.

U.S. Linkage of Conditions to Multilateral Programs

In a December 21, 1984, letter to GAO in which it outlined its views on the conditioning of bilateral and multilateral assistance to facilitate economic adjustment, the Treasury stated:

"The IMF is a recognized expert on economic adjustment with universal credibility In general, the United States agrees with the Fund on the goals of adjustment and means to achieve them. Therefore, the simplest means to promote economic recovery for troubled debtors is to support the adjustment programs they develop with the IMF For the recipient, dealing with the IMF offers protection from charges of acquiescing to U S. interference in their internal affairs. In financial terms, an IMF program is a universally recognized seal of approval and brings with it restored confidence among commercial creditors, resumption of trade credit lines, and access to debt rescheduling "

The AID Latin America Bureau's 1983 strategic plan also recognized the need to encourage recipient governments to undertake IMF stabilization programs. "Once IMF programs are in place, our resources serve to minimize the needed austerity allowing countries to maintain import levels and living standards above those than would otherwise be required by the circumstances." Such U.S. support "buys time while more permanent structural changes are being put into place." The plan sets forth that

"In order to assure that our assistance eases adjustment rather than perpetuates unsustainable policies, our approach has been to make an IMF-supported stabilization program a prerequisite for major AID balance-of-payments assistance In addition, we shall try to leverage this assistance to achieve policies by host governments which will promote structural reform and long-run development. This will sometimes involve coordination with World Bank structural adjustment programs Once stabilization objectives are met, it is our hope that the policy framework established through leveraged assistance and policy dialogues will be substantially more favorable to development than those pursued in the past, permitting a rapid phaseout of AID balance-of-payments assistance "

IMF Arrangements

Stand-by arrangements are the principal means by which the IMF[3] provides short-term, below market-rate loans to member countries facing balance-of-payments difficulties.[4] Arrangements generally are 12- to 22-month programs, with loan disbursements made on a quarterly basis and subject to the implementation of specific conditions which may include adjustment in exchange rates, domestic credit, public sector spending, and foreign borrowing, among others, in order to ensure that the recipient government undertakes the necessary economic stabilization changes

The financial resources provided by the IMF and other donors are not to be used to avoid making these economic reforms, but are intended to ease the pain of austerity measures and allow for a smoother transition during the restructuring of the economy. Too generous a provision of financial assistance may enable the country to delay or avoid the necessary adjustment. The transition period is often quite painful and may last for several years before sustainable economic growth resumes;

[3]The International Monetary Fund was created at the Bretton Woods conference in 1944 and its Articles of Agreement state that an IMF purpose is to facilitate the expansion and balanced growth of world trade

[4]As of April 30, 1985, the Fund has approved 570 stand-by arrangements for a total of about $50 billion. In 1974 the IMF also created the Extended Fund Facility (EFF) to provide larger loans in support of 3-year adjustment programs for member countries having deep seated balance-of-payments problems, 33 EFF arrangements have been approved for about $25 billion

labor and other resources do not move instantaneously or smoothly from one productive activity to another. Instead, the period may be characterized by growing unemployment, increasing poverty, a declining standard of living, and decreasing domestic and foreign investment. Adjustment measures are deemed necessary to prevent a worsening of conditions, achieve stabilization, and establish the environment for future economic growth.

When requesting a stand-by arrangement, the recipient government submits a "letter of intent" to the IMF in which performance criteria are set forth. The recipient government's failure to meet these performance criteria may result in postponement of loan disbursements and suspension and/or cancellation of the arrangement. The IMF may assign a resident representative to the country to monitor government performance and provide technical assistance.

World Bank Structural Adjustment Lending

Some critics of the IMF approach have looked to the World Bank[5] to develop an alternative program which deals with a country's immediate balance-of-payments problem but within a long-term growth framework. The Bank designed a nonproject lending scheme in 1980 and was authorized to begin a program of structural adjustment loans (SALS). The program is to help developing countries carry out the difficult process of policy and institutional reform in an unfavorable international economic environment. The SALS are stretched out over a number of years in recognition that structural adjustment reforms require time. Unlike IMF stand-by arrangements, World Bank SALS carry long-term maturities.

The 1985 World Bank annual report set forth that

> "To achieve the objectives of structural adjustment lending—reducing the current account deficit to a sustainable level and maintaining or restoring growth—the Bank has sought improvements in four interrelated areas: trade policy, mobilization of domestic and foreign resources, efficiency in the use of domestic resources, and institutional reform (i e , simplifying export/import procedures, streamlining foreign investment procedures, etc) The precise blend of these reforms, the specific measures chosen to implement them, their timing, and the particular sector focus have depended on several factors, including a country's initial economic condition and the strengths and weaknesses of its institutions "

[5]The World Bank (or International Bank for Reconstruction and Development, and sister institution of the IMF) was created at the 1944 Bretton Woods conference to facilitate the international flow and investment of capital for productive purposes

Congressional Objections to U.S. Linkage With the IMF

Some critics of the IMF approach feel that steps taken to achieve short-term stabilization may in fact retard future economic growth. Reductions in government spending usually result in cutbacks in expenditures for power plants, roads, education, and other infrastructure investment. Complementary private-sector investment, which is dependent on this public investment, may also be cut. Critics maintain that IMF-imposed currency devaluations raise the price of imports, thus fueling inflation and raising the cost of production, which further fuel the inflationary spiral and lay the groundwork for future devaluations. Higher import prices and the requirement to rebuild international reserves reduce the quantity of imported capital equipment, spare parts, and intermediate goods, thus reducing domestic production. Austerity, higher domestic prices due to currency devaluation and reductions in government subsidies, and higher taxes reduce domestic savings despite the favorable effects of positive, real interest rates which could result. The net result, according to critics, may be little, if any, increase in productive capacity and poor prospects for growth within the next few years

The House Committee on Appropriations noted in its report to the 1985 appropriation that "on occasion actions required by [IMF arrangements have caused political unrest and severe economic hardship." The Committee also noted in its report to the 1984 supplemental that

> ". funds are being withheld by AID in support of austerity programs imposed by the International Monetary Fund The intent of appropriating these funds was not to support the IMF but to further the foreign policy objectives of the United States "

Congressional concerns leading to the Kemp-Kasten amendment were outlined by an amendment sponsor in a June 1984 letter to the Secretary of State. The sponsor wrote that while the government of Jamaica faced budget and foreign exchange problems because it "failed to institute pro-growth, incentive oriented economic policies..." the IMF and AID austerity programs were aimed at the people. Further, the sponsor wrote that IMF conditionality was "in direct contradiction to the economic policies which we support in our bilateral aid " In a subsequent letter in September 1984, the sponsors wrote that

> "We do not believe it is in the best interest of the United States to subordinate our bilateral assistance programs to the decisions of the IMF under any circumstances...."

AID had recognized the need for such independent judgment prior to the amendment. In 1982 the AID Administrator issued policy guidelines which emphasized the requirement for independent economic analyses by AID economists. Nevertheless, in response to congressional action, in late 1984 AID eliminated direct references to the IMF in setting forth conditions on U.S. assistance. The AID Administrator instructed AID missions that the U.S. government must make judgments, independently of the IMF, on appropriate economic adjustment measures.

Since the AID missions made independent assessments of the need for recipient-government reform efforts, the amendment had not significantly changed the setting of conditions in the missions we examined. In Costa Rica, a U.S. Embassy official said that the amendment had made no significant difference for AID since the State Department and AID operate under the assumption that Costa Rica will comply with the IMF He further said that the IMF, World Bank, and United States are all players in the policy dialogue; conditions must be mutually reinforcing and the need for certain policy reform measures is obvious. A senior AID official to the Dominican Republic said that the changes in mission operations (i.e., emphasis on policy reform and private sector development) were strictly AID policy to bring the mission "into the 20th century" and that they had nothing to do with the Kemp-Kasten amendment. He added that it is not critical to refer (or not refer) to the IMF in conditioning U.S. assistance since the major concern is to focus on adjustment and encourage growth.

The impact of the amendment in Jamaica and Liberia was similar to that found in Costa Rica and the Dominican Republic. The AID economist in Jamaica said that the amendment did not impose requirements to do anything new since the mission had never blindly accepted IMF or World Bank prescriptions. He added that he had conducted independent economic analysis for AID reform efforts since his arrival at the mission in June 1982. An AID official in Liberia said that the mission had purged its ESF agreement of overt references to IMF conditions in accordance with the legislation. He continued that while AID usually agreed with the IMF, it arrived at its own decisions and conditions and the amendment had not significantly changed this decision-making process.

Debt Rescheduling and the IMF

In response to congressional interest in U.S. debt rescheduling policy, the National Advisory Council on International Monetary and Financial Policies (NAC)[6] issued a formal policy statement on official debt

[6]The U S government interagency body established to set and enforce U S debt rescheduling policy It is chaired by the Secretary of the Treasury and composed of the Treasury, State, Commerce, U S Special Trade Representative, International Development and Cooperation Agency, Export-Import Bank, and Federal Reserve Board

rescheduling in 1978. The policy effectively provides that a debt-rescheduling arrangement is contingent upon the recipient-country obtaining and/or complying with an IMF stabilization arrangement. Moreover, the policy provides that debt relief may be authorized only for countries in default or facing imminent default, according to the Treasury, and may be provided only in a multilateral framework so that the United States is not disadvantaged relative to other official bilateral creditors. This policy remains in effect, and a Treasury official said that the Administration has no intention of making any fundamental change to the policy, including the linkage between an IMF arrangement and debt rescheduling.

As a practical matter, commercial lenders also generally require an IMF arrangement as a precondition to commercial debt rescheduling. For example, in 1984 in Costa Rica, the existence of an IMF arrangement was a prior condition for the rescheduling of official and commercial debt, as well as for contracting a World Bank structural adjustment loan, which were worth about $260 million to Costa Rica. The Assistant Administrator of AID's Latin America bureau wrote to the Administrator in 1983 that the economic difficulties of Costa Rica, the Dominican Republic and Jamaica "...require IMF action to assure that other external creditors do not pull out and other potential donors continue to participate."

Although the Kemp-Kasten amendment restricts direct linkage of obligation and disbursement of U.S. funds with IMF arrangements, AID program success depends in part upon recipient-country debt reschedulings and access to new loans and trade credits due to the countries' large financial needs. (AID economic projections for some countries assume annual debt reschedulings through 1990.) Thus, effective use of U.S. ESF balance-of-payments assistance may be dependent upon an IMF program.

Conclusions

AID's objective in providing ESF balance-of-payments assistance is to promote economic and political stability. Its goal in attaching conditions to assistance is to reduce recipient-countries' dependence on such assistance in the future. AID program success in some cases depends in part on recipient countries' debt rescheduling and access to new loans and trade credits which, in practical terms, require an IMF arrangement. Consequently, AID frequently conditioned its balance-of-payments assistance on recipient governments' entering into IMF arrangements or, if arrangements were in place, compliance with their performance criteria.

Since the AID missions made independent assessments of the need for recipient-government reform efforts, the Kemp-Kasten amendment has not significantly changed the setting of conditions in the missions we examined. However, AID economic projections for some countries assume annual debt reschedulings through 1990, and thus, effective use of U.S. ESF balance-of-payments assistance may be dependent upon an IMF program.

AID's Use of Conditions in Four Countries

The U.S. objectives for Costa Rica, the Dominican Republic, and Jamaica are economic and political stability and the maintenance of democratic governments, along with improved economic growth and development and eventual elimination of their need for U S. balance-of-payments support. The objectives in Liberia also include the U.S. goal to see that country return to a democratic form of government. AID attached conditions to its ESF balance-of-payments assistance directed toward economic stabilization, structural adjustment, and individual country circumstances AID experienced both success and failure in achieving its conditionality goals in the four countries. Table 3.1 shows U.S. ESF assistance levels for fiscal years 1982-85.

Table 3.1: U.S. ESF Assistance for Fiscal Years 1982-85

Dollars in millions

Fiscal year	Costa Rica	Dominican Republic	Jamaica	Liberia
1982	$ 20	$ 41[a]	$ 90[a]	$ 35
1983	157[b]	8[b]	59[b]	32
1984	130[c]	34	55	35
1985	160	95[c]	81	43
Totals	**$467**	**$178**	**$285**	**$145**

[a]Includes 1982 supplemental

[b]Includes 1983 supplemental

[c]Includes 1984 supplemental

Source AID

Economic Problems in Recipient Countries

The economic problems in these countries are not just passing phenomena, but a combination of domestic policy errors, long-term structural trends whose unfavorable effects have been accumulating for the past decade, and short-term external circumstances such as the 1980 petroleum price increases. These countries instituted policies in response to negative external influences, which further exacerbated the problems.

Like most small, developing nations with open economies, these countries have always been vulnerable to external forces. They faced international oil crises in 1973-74 and 1978-80, and due to economic recessions in the industrialized countries, a sharp decline in export earnings from their major export products occurred. Costa Rica and the Dominican Republic faced deterioration of coffee and sugar prices, Jamaica experienced a plunge in export volumes of alumina and bauxite, and Liberia suffered significant declines in iron ore and rubber exports. These factors had profound effects on the countries' gross domestic product (GDP), balance of trade, public finances, and external debt and ability to service this debt.

The countries compounded the problems by continuing their extensive outlays in public sector expenditures. For example, Costa Rica, the Dominican Republic, and Jamaica expanded funding of social programs and strained financial resources with various subsidy expenditures, adding to inflationary pressures and the difficulty of managing already fragile balance-of-payments prospects. Liberian construction costs on facilities for the 1979 Organization of African Unity Conference were estimated at between $80 million and $100 million, most of which Liberia borrowed from commercial lenders at relatively high interest rates. In effect, the sharp economic deterioration of the early 1980s was preceded by the classical "living beyond one's means."

The nature, extent, and duration of the problems in Costa Rica, the Dominican Republic, and Jamaica may be explained by the long-term structural features of their economies. The private sectors of each country had operated in the protected environment of an import-substitution development strategy. By the early 1970s the limitations of this strategy had become apparent; the relatively easy substitution possibilities had been maximized, and the Caribbean and Central American markets for regional trade proved to be small, easily saturated, and unreliable.

Unfortunately, the import substitution strategies produced a set of policies which worked together to create a distinct anti-export trade environment. The policies supporting high levels of effective industrial protection, overvalued exchange rates, and subsidized interest rates, resulted in industrial structures that were too capital and import intensive, and had considerable excess capacity. Consequently, each country's industrial sector was not competitive in the world market. Liberia's economic problems are attributable to a basic lack of government revenue coupled with uncontrolled extrabudgetary[1] expenditures.

The governments' policy responses to the crises varied by type and in the timing of adjustments. However, all the countries eventually sought and received increased financial assistance from the United States and

[1]Extrabudgetary expenditures are (nonbudgeted) payments for items not included in the national budget

IMF. Each country, except for the Dominican Republic, also sought World Bank structural adjustment loans.

AID Conditions to ESF Assistance

The United States uses three types of policy-related conditions—conditions precedent, covenants, and prior actions A "condition precedent" is an action that the United States requires a recipient government to take before assistance funds are disbursed. A "covenant" is an action that the United States requires a recipient government to take before, during, or after assistance is provided, but is not tied to the disbursement of the funds. A "prior action" is an understanding between the United States and a recipient government (but is not written into any formal agreements) on actions the host government will take prior to the disbursement of U.S. funds.

If the U.S. government decides to condition its assistance on policy reforms, it can use a number of instruments. The United States and recipient governments may exchange formal letters or informal written agreements outlining the policy measures to be undertaken by the recipient government, or the recipient government may make an unwritten commitment to the United States if the measures are of particular sensitivity.

AID conditions usually require such reforms as exchange rate adjustments, reductions and/or elimination of subsidies (i.e., changing the market rate for gasoline, electricity, etc.), divestiture of public-sector enterprises and promotion of the private sector, and restraints on public-sector employment and wages. Rescheduling of foreign debt often figures heavily in the restoration of stability and therefore is frequently a necessary component in the AID program. Until 1985, AID required recipient-country compliance with IMF and World Bank programs. AID conditions have generally been closely coordinated with the IMF and World Bank in Costa Rica and Jamaica. Coordination in the Dominican Republic was hampered by problems within and among the U.S. and IMF programs; there was no World Bank SAL in the Dominican Republic. Coordination was similarly effected in Liberia due to the country's arrearages for loan repayments to the IMF and World Bank, which prevented Liberia's further access to IMF and Bank resources.

IMF conditions common to all four countries were limiting the growth of public debt, capping credit to the public sector, reducing the current account balance-of-payments deficit, and replenishing the international reserves of the central banks World Bank SALs are directed towards tariff reforms in Costa Rica and Jamaica, and the planned SAL for Liberia included restraints on public expenditures and revisions in public-sector wage and employment policies. Dominican Republic officials said that their government had no interest in a SAL due to the stringent conditions imposed by the Bank.

Conditionality in Costa Rica

In coordination with the IMF and World Bank, AID influenced the Costa Rican government to adjust its exchange rate, remove disincentives to private sector development and export production, revise the banking and currency laws, and adopt IMF stand-by arrangements. AID's principal means for setting conditions was through the use of covenants, although conditions precedent were used in December 1982 to get the government to agree to an IMF arrangement. The AID mission also began using prior actions in 1984 directed toward Costa Rican General Assembly approval of the banking/currency law and adoption of another IMF arrangement.

U S objectives for Costa Rica in 1983 were to arrest economic decline, while preserving Costa Rican democracy, by conditioning fiscal year 1983 assistance on compliance with the IMF arrangement. AID obligated $467 million in ESF between fiscal years 1982 and 1985, focused primarily on support to Costa Rica's balance-of-payments problems (see table 3.1). Largely as a result of this approach and the successful rescheduling of foreign debt, Costa Rica's balance-of-payments gap was closed, inflation dropped from over 90 percent in 1982 to about 12 percent in 1984, the multiple exchange rates were unified and stabilized, the public sector deficit was reduced, and large amounts of credits were redirected for private-sector use. According to AID, a degree of stability was achieved by 1984. Costa Rica reduced its current account deficit and registered positive GDP growth rates for 1983 and 1984, but its foreign debt has gone from $2.8 billion in 1980 to $4.1 billion in 1984.

Structural Adjustment Followed Stabilization

With progress made on stabilizing the Costa Rican economy, AID shifted its emphasis to include structural reform strategies to yield sustained, export-led economic growth. In conjunction with the IMF and World Bank, AID got the government to undertake a number of major macroeconomic reforms necessary for sustainable, long-term growth. For example, AID conditionality required legislative approval of amendments to the currency and banking laws. These changes revised the exchange rate for repayments of loans and gave private commercial banks direct access to Central Bank credit operations, facilitating dollar-denominated lending[2] by all credit institutions. Without these amendments, dollar-denominated lending was not readily available to support private-sector, export-related activities.

Although the Costa Rican General Assembly and general public understood that AID was withholding ESF money in 1984 as leverage on the Costa Rican administration to secure passage of this law by the legislature, AID was quietly making disbursements throughout the period because withholding funds would have resulted in disastrous balance-of-payments problems. The Costa Rican administration in return worked to secure passage of the legislative amendments, which it accomplished

AID is also assisting the government to begin the divestiture of the Costa Rican Development Corporation (CODESA). CODESA was the sole owner or majority shareholder of 18 commercial enterprises. A public corporation, CODESA lacked the technical and management skills needed to make the companies financially viable. Consequently, it borrowed heavily to keep these concerns operating, consistently accounting for one-third of all borrowing by the public sector. In promoting divestiture, AID contributes to the stabilization process by encouraging the government to achieve a significant reduction in public sector debt, decrease future public sector demand for credit, and permit more rational allocation of credit to the productive private sector.

Level of Assistance Is Important

The amount and timing of U.S. assistance can strongly affect recipient governments' ability and/or willingness to implement macroeconomic reform measures. In Costa Rica, for example, the ESF program expanded rapidly since its inception in 1982 at $20 million to $157 million in 1983 and $160 million in 1985. This dramatic increase in U.S. assistance allowed Costa Rica to undergo rapid adjustment without much negative austerity, and was crucial to government efforts to bring about exchange rate stability and reduction in the rate of inflation. The AID mission economist said that the high level of U.S. assistance was a principal reason for AID's success in Costa Rica. He added that austerity measures caused no undue hardship because the United States had "cushioned" the effects of the IMF program. The president of the Central Bank noted that while the middle class bore the burden of a reduced standard of living, the practical effects of austerity were "vacationing in Costa Rica itself rather than Florida, and maintaining an automobile for

[2]Dollar-denominated lending uses U S. dollars rather than local currency in the transaction process (lending and repayment)

a few years longer rather than buying a new one." Young people could not afford housing, and a private economist noted that large numbers of recent college graduates had been unable to obtain expected employment. These problems may worsen in the near future and could possibly result in some social unrest.

In Costa Rica, composition of the ESF program changed from a loan-grant mix to pure grant in 1984-85. According to AID economists, the advantages of ESF grants were that local currency was freed for use in development projects and the foreign debt level was not increased. The economists also emphasized that employing the grant approach avoided a Costa Rican Assembly debate over U.S. conditions, while a loan would require approval and debate, and could have resulted in unwanted anti-American rhetoric.

Conditionality in the Dominican Republic

ESF assistance to the Dominican Republic was linked to Dominican government compliance with IMF arrangements for 1982 and 1983; in 1984 AID also required the government to move certain import items to the parallel exchange rate market[3] and agree to specific IMF performance criteria. Conditions were set by AID/Washington due to the AID mission's reluctance to use ESF for conditioned economic reforms. In late 1984, the mission agreed with AID/Washington on the need for conditioned U.S. assistance and subsequently conditioned U.S. assistance on the government's unifying the exchange rate; raising petroleum prices and electricity rates; adjusting government budget figures; and rescheduling external debt, among other measures AID used both conditions precedent and prior actions in the Dominican Republic

Stabilization Efforts

AID conditionality in the Dominican Republic shared similar macroeconomic goals with those of Costa Rica: promotion of private-sector investment, export expansion, agricultural diversification, and public-sector divestitures. However, the government was hesitant to act and has not made great strides beyond initial reforms aimed at stabilization. According to a high level U.S. official, setting conditions was complicated by the fact that due to U.S. military intervention in 1916-24 (when the United States assumed management of Dominican customs

[3]The Dominican Republic had a dual exchange market consisting of an official exchange rate of Dominican Republic $1 00 to U S $1 00, and a parallel rate, which was freely determined by market forces, for specific transactions

revenues), the Dominicans resent foreigners "coming in and telling them how to handle their finances."

AID withheld the disbursement of the fiscal year 1984 $50-million ESF supplemental funding because the government had not complied with the conditions to unify the exchange rates and raise petroleum and electricity prices (among other measures). The ESF funding was disbursed in late December 1984 in return for government promises to adopt the measures in early 1985. The measures were undertaken in a series of executive decrees announced one month after AID disbursed the funds.

AID's structural adjustment goal will require a significant reordering of the Dominican economy. However, the government had demonstrated little interest in implementing key reform in areas such as divestiture of public enterprises (although a high U.S. official stated that the Dominican president had demonstrated some receptivity on this issue) and removal of surcharges on exports Embassy and mission officials stated that Dominican officials recognized that a 36-percent surcharge on traditional exports and 5-percent surcharge on nontraditional exports were disincentives but the government needed the revenue generated and these taxes might not be easily eliminated. In its comments on the report, AID noted that the 5-percent surcharge had been eliminated and the 36-percent surcharge reduced to 18 percent. The Dominican Republic has faced severe inflation and a negative current account, and has had a declining gross domestic product growth rate since 1983. Its debt level went from $2 0 billion in 1980 to $3.1 billion in 1984.

U.S. Assistance Levels

U S ESF assistance to the Dominican Republic from 1982-84 totaled $83 million, significantly less than the $247 million it provided to Costa Rica in this period (see table 3 1). An AID economist, in comparing ESF assistance in Costa Rica to that in the Dominican Republic and Jamaica, said that the latter countries just did not receive enough resources, such as ESF, to cover their balance-of-payment deficits. A high-level U.S official to the Dominican Republic also noted that the adjustment process in the Dominican Republic has been too gradual and indicated that this might be attributed to insufficient external funding from 1982-84. The official emphasized, however, that the $50 million 1984 supplemental combined with the 1985 appropriation of $45 million, and the proposed $50 million for 1986 were adequate amounts for assisting the Dominican Republic.

In January 1983 the IMF and Dominican government agreed on a 3-year IMF program of approximately $450 million. The program's criteria included reduction of the current account deficit, expansion of free trade zones to encourage investment, revision of the tax structure, reduction of public sector borrowing, and reduction of external arrearages. The government met IMF performance criteria through September 1983, but by the end of that year the government was substantially out of compliance and the arrangement was suspended. Negotiations for continuing the second year of the IMF program were terminated due to government reluctance to transfer petroleum imports to a parallel market-rate of exchange with higher costs to importers. The program also required an appropriate pass-through of the higher domestic prices to consumers. The adherence to oil subsidies was based on the government's political judgment that continued rapid reduction in real income would cause social violence. Ultimately the IMF program was cancelled, the government forfeited $250 million in IMF money, and reforms were delayed. U.S. officials said that part of the delay in the government obtaining a new IMF arrangement was from an internal dispute within the IMF on treatment of the Dominican Republic. We believe, and AID officials agreed, that increased U S. ESF assistance levels in 1983-84 could have "cushioned" the requisite IMF austerity measures as in Costa Rica, allowed the Dominican Republic to stay on course with the original IMF program, and expedited essential reforms However, in its comments, the Treasury Department noted that the Dominican Republic "was doing everything wrong and ESF would not have helped."

ESF assistance to the Dominican Republic was in loan form for 1982 through 1984, but the fiscal year 1984 supplement of $50 million was a grant. The AID mission proposed the grant approach to (1) increase the leverage that could be obtained in terms of the government's acceptance of conditionality, (2) increase the speed and flexibility in reaching an agreement since, as in Costa Rica, a grant need not be approved by the Dominican Congress; and (3) avoid increasing the foreign debt level.

Conditionality in Jamaica

AID has used conditions precedent and covenants for Jamaica, but U.S. objectives appear to have set a higher priority on immediate political interests rather than economic reforms. A mission official who participated as a member of the team which negotiated AID conditions with the government of Jamaica said that AID had great difficulty in negotiating with the government and maintaining mission credibility because the Jamaican prime minister believed he could by-pass AID and go directly to the U.S. president when he objected to U.S. conditions. AID did successfully withhold an ESF disbursement in 1984 to encourage the government to reach agreement with the IMF. Compliance with the IMF and/or the World Bank program also appeared as a condition precedent in every ESF agreement between 1981 and 1984. However, this condition was not in the 1985 ESF agreement. The IMF, World Bank, and AID divided their reform emphases; AID's interests included exchange rate adjustment, divestiture of public enterprises, trade promotion, and tax reform. The IMF's concerns included balancing expenditures with revenues and removal of various subsidies, while the World Bank's interests included reducing the size of government employment and number of government agencies, and development of capital needs for public works such as roads and schools.

AID's Use of Conditions

AID began using covenants rather than conditions precedent to its assistance in 1984. The covenants spelled out actions AID would like the government to undertake rather than requirements that must be met by a specific date. An embassy official said that covenants were preferable since they did not impact on the "sovereign image" of Jamaica and avoided having U.S. demands brought into the open for public debate.

Overall, the Jamaican government was slow to act on policy reforms. Only 3 of the 11 macroeconomic areas (exchange rate adjustments, price control relaxations, and tax revisions) being promoted by donors were expected to be substantially addressed by the government by 1986. However, timely actions by the government were hampered by the decline of the bauxite/alumina industry, the government's belief in a managed economy, and civil disturbances and pressures from the opposition political party.

The conversion of ESF loans to grants to expedite reforms was considered but rejected by the AID mission. Using loans was viewed as a potential means to obtain substantive reforms, while grants offered the government an actual quid pro quo for policy actions. However, an AID official said the conversion of loans to grants would be of minimal effectiveness due to the overwhelming nature of Jamaica's debt and the projected negative growth in GDP for 1985. The AID mission economist said that Jamaica was the toughest case to "put right" since the major sources of foreign exchange earnings were tourism and bauxite, and only tourism was a potential source for increased earnings due to the decline in the bauxite market.

Jamaica experienced a real GDP decline of -0.39 percent in 1984. Figures for 1985 were not available as of June 1986. Despite the improvement in public-sector finances and restrictive monetary policy, the current account ratio to GDP has continued to decline. Major shortfalls in traditional exports and tourism undercut government adjustment attempts. Jamaica's foreign debt rose from $1.9 billion in 1980 to $2.6 billion in 1982 to $3.1 billion in 1984.

Conditionality in Liberia

U.S. conditionality for Liberia was different from that of the other countries and reflected the unique circumstances of the Liberian economy. The country is not subject to the typical stabilization and reform efforts associated with exchange rates because the Liberian currency is the U.S. dollar. The overriding problems in Liberia were extrabudgetary expenditures and inadequate revenue generation.

The objectives of AID's economic support assistance in Liberia were to provide immediate balance-of-payments support to ensure that foreign exchange requirements were met and to encourage continued progress in implementing fiscal reforms and adoption of economic policies required for stabilization. As of June 1985, the government of Liberia was about $83 million in arrears on its external debt payments, consisting of a $28 million arrearage to the IMF and $54 million to other creditors such as the World Bank, African Development Bank, commercial banks, and bilateral creditors, including the United States. IMF procedures do not allow disbursement of funds to a country in arrears to the Fund. An embassy official said that the United States had also suspended disbursements of fiscal year 1985 ESF assistance because the financial situation was so poor that continuing disbursements could have postponed but not prevented arrearages to the IMF and other foreign creditors. AID officials said that without foreign financing, Liberia would be unable to meet external obligations, have trouble maintaining its domestic economy, and have no money for development efforts. While fiscal year 1985 funds were subsequently disbursed, a State Department spokesman noted in commenting on the report that the United States had not disbursed fiscal year 1986 money in light of the absence of a credible Liberian government strategy for dealing with its domestic and external problems, as well as U.S. concerns about political developments in Liberia. He noted that these issues were being discussed with the Liberian government.

U.S. Assistance Approach

Prior to fiscal year 1983, ESF grants were used to pay for crude oil imports which the state-owned Liberian Petroleum Refining Corporation refined and sold. The money generated from sales was then supposed to be set aside by the government, in the amount equivalent to the grants, and used for development activities agreed upon by AID and the government.

As Liberia's external debts mounted, the United States decided it was more important to use ESF for external debt payments. Most of the 1983 and all of the 1984 and 1985 grant funds were used in this manner. Conditions and covenants attached to these grants were aimed at strengthening fiscal management, revenue collection, and debt management. For example, AID officials said that a lack of discipline and insufficient spending controls allowed extrabudgetary expenditures for such things as an executive jet desired by the Liberian government leader. Various Liberian officials said that AID conditions were reasonable and that AID, government officials, and the IMF generally agreed on the goals of the adjustment program. According to the AID officials, Liberian officials themselves occasionally suggested potential conditions to AID. A senior government official said that AID's conditions supported his efforts to get the government to control expenditures, and that there was support at the technical level within the government for U.S. conditionality.

Although AID consistently determined that government ministries complied with its conditions, it withheld some ESF disbursements in order to force compliance. Embassy and mission officials said that a major purpose in withholding ESF disbursements, which contributed to continuing Liberian arrearages to the IMF and World Bank, was to encourage cooperation with, and get more money from, the IMF and World Bank in addressing the financial gap. However, the State Department spokesman, in commenting on the report, said that encouraging cooperation with the IMF and World Bank was not a factor in withholding disbursements.

Problems in Economic Management

In some cases, government compliance with AID conditions was neither timely nor did it produce the desired effect due to inappropriate recipient-government actions. For example, the last three ESF grants stressed the need to increase revenue collection, but revenues continually fell short of expectations. One reason was the depressed export market, but another was directly attributable to actions by the head of the Liberian government According to a mission official, in mid-1984, the Liberian leader created a "task force" of military personnel to collect taxes. However, the task force did not remit the collections to the government. The Liberian leader was eventually convinced to disband the task force.

Since many decisions on revenues and expenditures were made personally by the Liberian leader, the government continued to have severe problems with extrabudgetary expenditures and inadequate revenue generation despite government ministries' technical compliance with AID conditions. Problems increased, according to the IMF resident representative, when the August 1984 student riots and subsequent military crackdown led to a renewed loss of confidence for foreign investment and increased capital flight.

A high-level mission official said that while AID used conditions to "chip away" at problems, prospects for expenditure controls and better fiscal management were not expected to improve until after the October 1985 elections which were intended to return the country to civilian rule.[4] AID officials said that the government officials were beginning to realize that the United States could not continually increase its assistance levels, and that U.S. assistance could not and would not cover all Liberian budget requirements.

AID was successful in encouraging some government reforms by withholding ESF funds A high-level mission official said that AID's withholding of funds was responsible for the government's creation of a blocked account at the New York Federal Reserve Bank. The account required the government to use the funds to service external debt and prevented their diversion for general operating and extrabudgetary expenses. The official continued that this action substantiated that withholding disbursement of funds was a mechanism that could promote reform. The official noted that the mission was supported in its efforts at the Washington level; several Liberian officials unsuccessfully attempted to lobby in Washington for release of ESF funds. Because of the unified U.S posture on the issue, the officials were unsuccessful and the government consequently complied with AID conditions.

[4]Public Law 99-83, title VIII, section 807, also states that fiscal years 1986-87 security assistance to Liberia "is based on the expectation of a successful completion of free and fair elections, on a multiparty basis, in October 1985 and on a return to full civilian, constitutional rule " On January 23, 1986, the Assistant Secretary of State for African Affairs testified before the House Foreign Affairs subcommittees on Africa and on Human Rights and International Organizations that elections were only partly free or fair

Liberia showed an estimated GDP growth rate of 3 4 percent in 1984 and had a projected rate of 4.1 percent in 1985. Despite the efforts of Liberian government ministries, Liberia's foreign debt grew from $696 million in 1980 to $862 million in 1982, and $1.0 billion in 1984.

Conclusions

The U.S. objective in placing conditions on its balance-of-payments assistance is to encourage recipient countries to implement fundamental economic reforms which will promote economic and political stability and self-sustaining development. Conditions generally include such reforms as exchange rate adjustments, reductions, and/or elimination of subsidies, divestiture of public sector enterprises and promotion of the private sector, and rescheduling of foreign debt.

AID experienced a range of success in Costa Rica, the Dominican Republic, Jamaica, and Liberia. The United States was successful in getting timely Costa Rican compliance with conditions in large part because of the very high levels of assistance provided. Costa Rica reduced inflation and its current account deficit, and has registered positive GDP growth rates for 1983-85, but its foreign debt has gone from $2.8 billion in 1980 to $4.1 billion in 1984.

The Dominican Republic was reluctant to undertake reforms because of the severe social dislocations they might entail. Until 1985, U.S. aid levels were not of significant amounts to cushion these effects. When the United States provided considerably higher levels of assistance in late 1984 and 1985, the Dominican government adopted appropriate reforms. The Dominican Republic faced severe inflation and a negative current account and 1985 GDP growth rate. Its debt level has increased from $2.0 billion in 1980 to $3.1 billion in 1984.

Jamaican reforms lagged behind those of other countries, and U.S. political interests in the country weakened leverage for economic adjustments. Jamaica has experienced marginal decline in real GDP in 1984. Despite the improvements in central government finances the current account ratio to GDP has continued to decline. Major shortfalls in traditional exports and tourism undercut government adjustment attempts Jamaica's foreign debt rose from $1.9 billion in 1980 to $2.6 billion in 1982 to $3.1 billion in 1984.

Liberian government ministries implemented reforms and complied with U.S. conditionality, but extrabudgetary expenditures by the government leader, as well as external market conditions, hampered economic recovery. Liberia showed an estimated GDP growth rate of 3.4 percent in 1984 and a projected rate of 4.1 percent in 1985. Although it complied with IMF and U.S. programs for 5 years, Liberia is presently experiencing massive economic problems. A virtual halt on outside financing because of arrearages and a U.S. suspension of ESF disbursements prevented Liberia from meeting external debt obligations as well as maintaining those to its domestic economy. Despite the efforts of its ministries, Liberia's foreign debt grew from $696 million in 1980 to $862 million in 1982 and $1.0 billion in 1984.

A Cautionary Note: External Factors and Debt Burdens May Pose a Threat to Achieving U.S. Objectives

While AID's conditioned ESF assistance has helped the recipient countries to improve their current account balance-of-payments positions (except for Jamaica where the situation continued to deteriorate), the debt problems may present an additional hurdle in the path of long-term growth and development. The U.S. strategy for the countries' economic recovery includes provisions for diversifying and expanding exports in order for the countries to earn foreign exchange to pay their debts and to eventually reduce their dependence on foreign aid. Projections for export-oriented success, as assumed when conditions are set, are often based on many highly optimistic assumptions and factors which are beyond the control of the individual countries. Thus, continued economic and financial difficulties in the countries might necessitate higher than anticipated levels of U.S assistance in the future in order to accomplish U.S. objectives of promoting self-sustaining growth for the countries.

Balance-Of-Payments Improved but Debt Service Problems Remain

The policy reforms undertaken by the countries in response to AID conditions, as well as to those of the IMF and World Bank, have improved the fiscal and current account deficits as shown in table 4 1 The ratios of fiscal deficit to GDP and current account deficit to GDP, respectively, have improved (i.e decreased) over the past 3 years except for Jamaica where there was further deterioration of the current account ratio. While debt levels, as shown in table 4.2, have increased substantially, of greater concern is the debt service, measured as either foreign debt as a percentage of GDP or annual interest and amortization as a percent of exports (debt-service ratio), which worsened over the period 1980-85 (see table 4.1).

Table 4.1: Indicators of a Country's Economic Health, 1980-85

(ratios, measured in percent)

Country and indicator	1980	1981	1982	1983	1984	1985[a]
Costa Rica						
Foreign debt to GDP	56 81	124 42	132 87	140 37	115 69	126 28
Debt-service ratio[b]	29 42	27 20	24 83	61 91	31 38	67 71
Current account to GDP	−13 74	−15 59	−10 42	−10 29	−8 94	−5 88
Fiscal deficit to GDP	−13 29	−13 67	−9 31	−3 32	−2 33	−1 42
Dominican Republic						
Foreign debt to GDP	30 23	31 54	31 28	34 04	28 55	57 80
Debt service ratio[b]	22 29	19 85	29 32	30 95	47 20[a]	63 80
Current account to GDP	−10 10	−5 59	−5 54	−4 91	−4 30[a]	−0 60
Fiscal deficit to GDP	−6 00	−6 20	−6 20	−5 60	−7 50[a]	−4 90
Jamaica						
Foreign debt to GDP	70 45	71 78	78 83	82 75	130 79	N/A
Debt service ratio[b]	15 25	29 30	21 55	17 45	22 41	59 30
Current account to GDP	−6 23	−11 39	−12 46	−10 04	−13 14	−15 70
Fiscal deficit to GDP[c]	−17 00	−16 40	−16 40	−16 50	−7 80[a]	−7 00
Liberia[c]						
Foreign debt to GDP	75 95	92 57	103 26	105 00	110 00[a]	111 00
Debt service ratio[b]	6 32	4 99	6 83	6 99	9 00	26 56
Current account to GDP	−11 02	−7 23	−8 03	−12 13	−11 19[a]	−9 69
Fiscal deficit to GDP	−13 87	−10 38	−14 11	−8 90	−5 55[a]	−5 26

[a]Estimates

[b]Debt service includes principal and interest on all medium- and long-term debt It does not include repayments to the IMF or short-term debt For Jamaica, it excludes private, non-guaranteed debt service

[c]Covers fiscal years 1980-81, 1981-82, 1982-83, 1983-84, 1984-85, 1985-86

Source IMF and World Bank, June 1986

Table 4.2: Total Foreign Debt

Dollars in millions

	1980	1981	1982	1983	1984	Percent increase 1984 over 1980
Costa Rica	$2,745	$3,265	$3,463	$4,316	$4,122	50 2
Dominican Republic	$2,004	$2,292	$2,496	$2,919	$3,057	52 5
Jamaica	$1,879	$2,123	$2,585	$2,954	$3,107	65 4
Liberia	$ 696	$ 806	$ 862	$ 953	$1,007	44 6

Note Figures include long-term and short term public/publicly guaranteed debt and non-guaranteed private debt

Source World Bank

AID Strategy and Factors Which Impact Upon It

The AID strategy for the economic recovery of the recipient countries emphasizes adoption of domestic economic reforms, as discussed in chapter 3, and the need to diversify and expand the countries' export bases into nontraditional products which will be marketed primarily to the United States. These exports are intended to grow more rapidly than imports, generate an increase in net foreign exchange earnings, and enable the countries to service their foreign debt while stimulating long-term economic growth and development. Recent growth rates have been erratic as shown in table 4.3.

Table 4.3: Annual Growth Rates of Real GDP[a]

Figures in percent

	1980	1981	1982	1983	1984	1985
Costa Rica	0 75	−2 26	−7 28	2 86	7 47	1 57
Dominican Republic	6 06	4 06	1 68	3 94	0 37	−2 21
Jamaica	−5 81	2 49	0 97	2 02	−0 39	NA
Liberia	−4 74	−4 40	−6 17	−2 10	3 40[b]	4 10[b]

[a]GDP adjusted for inflation

[b]Estimates

Source IMF and World Bank

Developing countries' macroeconomic performance is influenced by both the external environment and their own policies. While appropriate domestic policies are necessary to enable a country to take advantage of improving world circumstances, they generally are not sufficient to lead to sustained growth and employment in the absence of favorable external forces. This is particularly true today given the enormous costs to service developing countries' external debt. Interest payments alone represent about 35 percent of export earnings for goods and services for the average Latin American country. Given the predominant influence of the industrialized countries in the world economy and the resulting environment within which developing countries must frame their policies, it is necessary to appreciate these realities so as to put developing countries' adjustment efforts in proper perspective.

Numerous projections have been made regarding developing countries' long-term economic prospects, including those of the IMF, Federal Reserve Bank of New York, Institute for International Economics, Morgan Guaranty Trust Company, and World Bank. Each prepared 5- to 10-year scenarios with similar assumptions on factors under which sustained economic growth is feasible.

The crucial external factors for recipient-country recovery are economic growth rate of the industrialized countries and accompanying growth of world trade, the level of real interest rates, and the availability of external financial capital. Another very important factor is the industrialized countries' trade policies upon which recipient-country exports depend.

According to an IMF official, many analyses imply that developing countries could resume sustained growth of 5 to 6 percent a year starting in 1987 or 1988 if

- growth in the industrialized countries is 3 to 4 percent a year,
- LIBOR[1] interest rates are 9 to 10 percent with global inflation of 5 to 6 percent a year through at least 1990 (a 4-percent real interest rate), and
- protectionism is not increased in industrialized countries.

While 1984 economic indicators came close to the above factors, the uncertainty of sustained growth in the industrialized countries, including the United States—which has special importance for Latin America's exports—casts doubt over the four case-study countries' growth prospects. Their earnings from exports to the United States are shown in table 4.4.

Table 4.4: Value of Merchandise Exports to the United States and Exports to the United States as a Percent of Total Exports in 1984

Dollars in millions

Country	Exports to U.S. 1983	1984	1985	Exports to U.S. as a percent of total exports in 1984
Costa Rica	$387.4	$ 472 5	$501 3	50 6
Dominican Republic	813 6	1,017 5	982 1	117 5[a]
Jamaica	272 6	376 6	272 7	51 0
Liberia	90 5	98 3	82 9	21 7

[a]U S Department of Commerce figures for Dominican exports to the United States exceed total exports to the world for the Dominican Republic as reported by the IMF According to a Dominican Central Bank official, this is due to under-invoicing by Dominican exporters in order to reduce their export taxes

Source U S Department of Commerce and the IMF

Furthermore, industrialized countries' trade protectionism appears to be increasing and may represent a major obstacle to future growth for developing countries. The success of the AID export-promotion strategy

[1]LIBOR (London Interbank Offered Rate) is a variable interest rate that banks charge one another for short-term borrowing It establishes a base rate to which other interest rates are pegged

is contingent on easy access to industrialized countries' markets, particularly the United States. The prospects for liberalizing current restrictions on imports, such as textiles, and avoiding imposition of additional barriers are uncertain.

To demonstrate the potential effects of external factors on a country's economic performance, we performed simulations for Costa Rica using an economic model constructed by Wharton Econometric Forecasting Associates.[2] The model provides a quantifiable measure of the impact on the Costa Rican economy of alternative scenarios. For example, one scenario assumes that the price of coffee would double in 1986 and then return to its baseline level for 1987-90. The immediate effect would be to increase the value of Costa Rican exports and raise the real growth of Costa Rica's GDP to 7.8 percent in 1986 as compared to the 1.7 percent baseline growth rate. By 1990, the gross foreign debt would be $269 million less than the baseline forecast while per capita consumption would be $19 more.

A second scenario assumes that the world price of oil would decline to $19 a barrel in 1986 and then gradually rise to $24 by 1990. The effect on the Costa Rican economy would be similar to that of the coffee-price simulation. By 1990, gross foreign debt would be $254 million less and per capita consumption $15 higher than the baseline forecast. The relatively small decline in foreign debt (6 percent) and increase in GDP (1.5 percent), given a 28 percent decline in 1986 oil prices, are partially explained by the relatively small level of fuel imports in Costa Rica's merchandise imports.

A third scenario assumes that annual world trade would grow 2 percent less than the Wharton baseline forecast, which averages a 9.1 percent nominal growth rate for 1986-90; the 1980-85 average was -0.4 percent. Compared to the 1990 baseline forecast, gross foreign debt would be $192 million higher and per capita consumption $56 less. To summarize, all scenarios demonstrate the sensitivity of the Costa Rican economy to external economic developments We expect that such sensitivity is not unique to Costa Rica, although the magnitude of the debt and consumption changes may vary among the case study countries.

The internal policies of industrialized countries also largely determine the growth rate for developing countries' exports taken as a group can

[2]See the tables in appendix I which summarize the baseline forecast for Costa Rica for 1985-90. This is the economic scenario considered most likely by Wharton analysts

grow, thus exerting a strong influence on actual aggregate developing-country export earnings, although there can be wide variations among individual countries in terms of whether their share of world exports is increasing or decreasing at any given time. According to a 1985 IMF survey of the industrial world, "better policies" (defined as improvements relative to a baseline that can be regarded as a realistic possibility) could add as much as one-half percentage point to industrial-country average annual growth rate during the period of 1986 to 1990. This improvement would help strengthen demand for exports from developing countries, lead to a gain (instead of no change) in the terms of trade on non-oil commodities, and help dampen protectionist pressures. These policies might add as much as 1 1/2 percentage points to the average growth rate of indebted developing countries.[3] Acting on their own and without the better industrial-country policies, these developing countries might add about one percentage point to the average growth rate of output by carrying out stronger policies.

"Worse policies" by industrialized countries such as large budget deficits, carry with them the danger of creating a significant recession, which, against a background of continuing financial fragility in developing countries, could have serious consequences. For indebted developing countries, "worse" policies by industrial countries could result in lower annual growth rates by 2 1/2 percentage points, resulting in negative per capita growth and accompanying declines in standards of living. Developing countries' policies, such as inadequate exchange rate policies and failure to contain fiscal deficits and monetary growth, would also severely hamper development efforts, but would reduce growth by only about one percentage point per annum.

Additionally, unless sufficient external capital is made available to countries which are following sound adjustment policies, growth will falter and the burden of debt servicing will continue to grow. The level of external capital required to allow for viable economic programs is substantial. For example, in Costa Rica, the cost of achieving AID's projected 5 percent rate of real GDP growth is estimated by AID to add $1.6 billion to Costa Rica's total foreign debt by 1990.[4]

[3]The IMF World Economic Outlook, April 1985, defines "indebted developing countries...to include all developing countries except the eight major oil exporting countries in the Middle East, for which comprehensive data on external debt are not available"

[4]The Costa Rican economist who participated in developing the Wharton country model for Costa Rica has projected a 1 4 to 2.2 annual percentage rate of growth for Costa Rica through 1990, but a decline in foreign debt of $76 million between 1984 and 1990

Domestic pressures in recipient countries to lessen the burden of austerity policies will increase. The Costa Rican middle class, which is bearing the brunt of austerity, expected its reduced standard of living to last only a few years, but present projections call for austerity at least through 1989. Some social unrest may occur in the near future. Both Jamaica and the Dominican Republic have already experienced civil disturbances, which were attributable in part to austerity, and future incidents are likely if austerity programs continue indefinitely. The unemployment rate in the Dominican Republic has been estimated to be 30 to 35 percent, although AID stated in its comments to the report that 20-25 percent unemployment applied to Santo Domingo and that unemployment rates were lower in the country as a whole. In Jamaica official unemployment was almost 25 percent in 1984 and probably higher in 1985. The governments may be hard pressed to use export earnings for debt service while domestic conditions continue to deteriorate.

Under optimistic assumptions that all principal and interest repayments are effectively rescheduled, export earnings must grow at least as fast as the interest rate to prevent a worsening of the debt-service ratios.[5] Additional borrowing, which is an integral assumption underlying all forecasts, will serve to further increase the already enormous debt levels and may further exacerbate debt-servicing problems.

Conclusions

The U.S. strategy for the economic recovery of Costa Rica and the Dominican Republic, through the use of AID conditions to ESF assistance, has been relatively successful in achieving stabilization but at a cost of contributing to increased debt-servicing requirements. As noted previously, the United States has been less successful in Jamaica and Liberia due in part to lack of cooperation with AID from these governments' leaders. The AID strategy for increasing the countries' exports in order to provide economic growth and the capability to service debt obligations is based upon optimistic assumptions, especially with regard to their ability to expand and diversify their export bases and attract substantial amounts of external capital. In addition, high growth levels for industrialized countries and their ability and willingness to accept

[5]The Simonsen criterion, named after a former planning minister of Brazil, "is that export earnings must be growing at a higher rate than the interest rate Otherwise, the country's debt burden tends to worsen The logic of this rule is that there is an automatic 'inherited' increase in debt by the amount of past debt multiplied by the interest rate, because this amount is the interest due on past debt If the country is achieving a balanced foreign account (current account) excluding interest, then its debt will grow by this amount. That is, its debt will grow by the interest rate " See William R Cline, International Debt and the Stability of the World Economy (Washington, D C · Institute for International Economics, 1983).

increased levels of developing-country exports are important assumptions. It is uncertain whether the strategy will be sufficient to promote self-sustaining economic growth in recipient countries. Given the current economic conditions these countries are in, and the rising debt-service burdens they are facing, it is likely that the recipient countries will continue to need increasing levels of ESF balance-of-payments support in the foreseeable future.

Agency Comments and Our Evaluation

A draft of the report was provided to the Department of State, Office of Management and Budget, Agency for International Development and Department of the Treasury. The State Department did not provide written comments but a Department spokesperson concurred with the draft report. A spokesperson for the Department's Africa Bureau noted that fiscal year 1986 ESF assistance to Liberia had not been disbursed due to the lack of a credible Liberian government economic strategy as well as to concerns about political developments in the country. These comments were incorporated in chapter 3. Written comments were provided by OMB, AID and the Treasury.

Office of Management and Budget

OMB noted that any development strategy pursued by AID must operate upon certain assumptions concerning exogenous factors. Given the economic growth record among industrialized countries and current favorable conditions, OMB believes sustained growth appears to be a reasonable assumption.

OMB noted that executive agencies generally agree on AID's strategy of conditioning assistance on economic reform and pursuing an export growth strategy. Further, while this strategy may not succeed in reducing future assistance requirements if external conditions worsen, alternative strategies are likely to result in still higher future U.S. assistance requirements.

OMB also noted that the alternative of no conditions on assistance would probably have resulted in lower economic growth and consumption, and similar levels of debt or the possibility of the countries going into default. We agree with the OMB comments.

Agency for International Development

AID generally concurred with the broad findings of the report but stressed that (1) U.S. strategy includes structural reform as well as stabilization, (2) domestic policy errors as well as external factors caused economic problems in the recipient countries, and (3) Jamaica has undertaken important reforms since 1983. We revised the Executive Summary to more explicitly recognize structural adjustment as an AID objective, and we clarified the report regarding domestic policy errors.

AID agreed that Jamaica's macroeconomic performance has been comparatively disappointing and that policy reform was not satisfactory prior to mid-1983. AID also noted that it has had "very substantial success" in Jamaica since 1983 and it cited various reforms undertaken by the government of Jamaica. We recognize that AID was promoting exchange rate and tax reform In addition, a number of reforms cited by AID were undertaken at the initiative of the IMF and World Bank. However, AID has weakened its conditionality in Jamaica since 1984 by replacing conditions, which were tied to disbursements, with covenants, which are not tied to disbursements. The Treasury Department commented that the AID program in Jamaica was "not a success."

AID also expressed concern with our characterization of its export strategy for Costa Rica, the Dominican Republic and Jamaica as based upon optimistic assumptions. AID said that the high growth rates between 1983 and 1985 for manufactures and non-traditional fruit and vegetable exports to the United States "strongly suggest considerable potential for non-traditional exports." AID said that, "for the three countries combined, the increase was 71 percent] between 1983 and 1985...[which was] substantially above our expectation of 40 [percent] growth." AID was cautious in noting that "much of this increase came from assembly operations, so that the U.S. import value substantially [emphasis added] exceeds the value added [foreign exchange earned] by the exporting country...."

One should note that 22 countries, including Costa Rica, the Dominican Republic, and Jamaica, have been designated by the Administration as beneficiaries of its Caribbean Basin Initiative. These countries are following similar export strategies predicated upon non-traditional exports. The countries export similar products which could lead to increased competition and thus potentially reduced prices and foreign exchange earnings.

AID is correct in stating that we did not "suggest any alternative strategy that is considered more promising" and we did not mean to imply that one exists. However, we do not believe that nontraditional exports can generate the needed foreign exchange within the foreseeable future to compensate for the decline in traditional exports' earnings and provide the solution to these countries' economic growth and debt-servicing problems. We are cautioning that the countries will probably continue to need increasing levels of U.S. balance-of-payments support.

Department of the Treasury

The Treasury Department commented that the discussion of debt rescheduling was misleading since "one could make the presumption that decisions on debt relief are predicated on AID's country objectives." The Treasury noted that U.S. debt rescheduling policy was outlined in the National Advisory Council on International Monetary and Financial Policies' 1978 policy statement. The 1978 policy statement which governs debt rescheduling actions of the United States is discussed in chapter 2. We did not intend nor do we believe the report implies that debt relief decisions are predicated on AID's country objectives.

The Treasury also pointed out that without IMF assistance, recipient countries would face further economic decline and hardship. We do not disagree with the Treasury and have discussed the need for IMF assistance and for policy reforms in the recipient countries in chapters 2 and 3. We note, however, that in the absence of a favorable external environment, the countries' efforts may not produce the economic stabilization and growth being promoted by the United States and multilateral institutions.

An Economic Model for Costa Rica

GAO contracted with Wharton Econometric Forecasting Associates to develop an appropriate model of the Costa Rican economy for use in examining the effects of various economic policy reforms. The model was designed to be readily used by AID as an additional means to develop appropriate economic reforms to serve as conditions to its balance-of-payments assistance. The model incorporates assumptions about the performance of the world economy and includes 14 policy variables so that alternative combinations of domestic policy reforms can be simulated and examined.[1] The model can be accessed on an IBM-compatible personal computer using "Lotus 1-2-3" software, and thus may be used at AID's overseas missions. Simulation results can be viewed on the screen and/or printed as a table or in graph form. The model can be easily updated as new information becomes available.

The economic model for Costa Rica combines elements of both a formal and informal model. The theoretical structure of the model is explicitly spelled out. The parameters are either calculated on the basis of historical data or set by assumptions of the analyst, and may vary over time. It is preferable for the parameter coefficients to be estimated econometrically. However, the Wharton consultant who constructed GAO's model felt that a pure, econometric model would be invalid "given the dramatic changes in the Costa Rican economy during the [1981-85 crisis [and that]...coefficients estimated through time series regressions could not reflect the actual values of the parameters."[2] Furthermore, due to severe data limitations, econometrically estimated behavioral

[1] Fiscal policy variables
—average tax rate, tax revenue as a percent of nominal GDP,
—average non-tax rate, non-tax revenue as a percent of nominal GDP,
—public enterprises current account surplus as a percent of nominal GDP,
—growth rate—real current expenditures—general government,
—growth rate—real capital expenditures—nonfinancial public sector, and
—nonfinancial public sector deficit as a percent of nominal GDP

Financial variables
—real rate of interest,
—growth rate—total domestic credit—nominal,
—growth rate—credit to the private sector—nominal,
—growth rate—net domestic assets—nominal,
—growth rate—bank reserves—nominal, and
—growth rate—credit to the public sector—nominal

Indexing parameters
—minimum wage adjustment coefficient and
—exchange rate devaluation coefficient

[2] Francisco Gutierrez was hired by Wharton to develop the country model for Costa Rica A citizen of Costa Rica, Mr Gutierrez did his doctoral work in economics at the University of Pennsylvania He is currently director of an economic consulting firm in Costa Rica which serves the AID mission in Costa Rica

equations would probably be unstable. However, the model has been designed so that such relationships can be readily incorporated if deemed appropriate.

The Costa Rican model consists of two sub-models which interact in a simultaneous manner. The domestic model is behavioral and consists of four major blocks: (1) national accounts; (2) financial sector; (3) public finances; and (4) country data, which contains information on population, labor and employment, wages, prices, and the foreign exchange and interest rates. The foreign sector, referred to as the country monitor model, is primarily an accounting framework and provides detailed information on balance-of-payments and foreign debt and trade

The Costa Rican model is linked to the world model through international economic variables, such as world trade, and international interest rates and export and import prices. The sub-models are linked through key variables. The variables accepted by the domestic model from the country monitor are exports and imports of goods and services and their price indices, change in net international reserves, external borrowing of the public sector, net factor income from abroad, and world inflation. The country monitor, in turn, accepts the following variables from the domestic model: real GDP growth, GDP deflator, nominal exchange rates, consumption and investment growth rates, and population.

A solution of the linked model requires convergence within each sub-model as well as between the sub-models. For example, the domestic model is calculated and said to converge when the change in 1990 Costa Rican real GDP is less than one million colones[3] (see table I.1). The appropriate data, as outlined above, is then passed from the domestic model to the country monitor. The country monitor is then recalculated and said to converge when the change in 1990 gross foreign debt is less than $100 million (see table I.2) The relevant data are then passed from the country monitor to the domestic model. This process continues until convergence in the general model is reached. Convergence in the general linked model is checked in the domestic model using the criteria that the change in 1990 real GDP is less than 0.075 percent.

The Wharton-constructed model is "user friendly." The software allows the user to select from a list of options to view historic data and the baseline forecast, modify assumptions, and make alternative conditional

[3]Costa Rican currency

forecasts. Both tables and charts displaying this information can be viewed on the computer screen and can easily be printed or plotted. The model gives historic data for 1980-84, estimates of recent results for 1985, and a forecast for 5 years (1986-90) for all key economic variables.

The following two tables are examples of the information provided by the model. The tables present the baseline forecast for the Costa Rican model incorporating Wharton's world forecast for October 1985. The summary table from the country monitor model has information on Costa Rica's foreign trade, balance of payments, foreign debt and debt service. The National Accounts table from the domestic model presents data and annual growth rates for the major sectors of the Costa Rican economy and levels of per capita income and consumption. The complete model presents data for more that 300 economic variables.

Table I.1: Domestic Forecast for Costa Rica/October 1985 Baseline

In millions of 1980 colones

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1999	1990
National Accounts											
Gross domestic product	41406	39518	37522	38402	40951	41513	42231	43018	43982	44986	45989
change (%)	−0.5	−4.6	−5.1	2.3	6.6	1.4	1.7	1.9	2.2	2.3	2.2
Primary sector	7372	7568	7384	7671	8285	8635	8995	9464	10028	10482	11037
change (%)	0.8	2.7	−2.4	3.9	8.0	4.2	4.2	5.2	6.0	4.5	5.3
Secondary sector	11096	10381	9196	9505	10489	11001	11402	11916	12315	12776	13291
change (%)	1.2	−6.4	−11.4	3.4	10.3	4.9	3.6	4.5	3.3	3.7	4.0
Tertiary sector	22937	21569	20942	21225	22176	21877	21833	21638	21639	21728	21661
change (%)	1.0	−6.0	−2.9	1.3	4.5	−1.3	−0.2	−0.9	0.0	0.4	−0.3
Total consumption	34684	29987	27164	29401	32370	31575	32144	33006	32661	32964	33145
change (%)	1.1	−13.5	−9.4	8.2	10.1	−2.5	1.8	2.7	−1.0	0.9	0.5
Private consumption	27140	23767	21703	23382	25452	25162	25598	26336	25998	26381	26706
change (%)	−1.8	−12.4	−8.7	7.7	8.9	−1.1	1.7	2.9	−1.3	1.5	1.2
Public consumption	7544	6219	5461	6019	6918	6412	6546	6670	6664	6583	6439
change (%)	1.5	−17.6	−12.2	10.2	14.9	−7.3	2.1	1.9	−0.1	−1.2	−2.2
Total fixed investment	9895	9507	7623	7008	6987	7774	8338	8813	9193	9535	9894
change (%)	−9.0	−3.9	−19.8	−8.1	−0.3	11.3	7.2	5.7	4.3	3.7	3.8
Private investment	6069	5809	4664	4318	4133	4461	4760	5043	5313	5575	5839
change (%)	−14.7	−4.3	−19.7	−7.4	−4.3	7.9	6.7	6.0	5.3	4.9	4.7
Public investment	3826	3698	2958	2691	2854	3314	3578	3770	3880	3960	4055
change (%)	1.6	−3.3	−20.0	−9.1	6.1	16.1	8.0	5.4	2.9	2.0	2.4
Inventory changes	1109	1964	1640	2481	1187	1045	1264	1707	1877	1971	2147
Net exports of goods & svcs	−4282	−1940	1095	−488	406	1119	485	−508	250	516	802
Exports	10963	17098	16916	13861	11843	13213	14665	15705	17313	18777	20138
Change (%)	−4.3	56.0	−1.1	−18.1	−14.6	11.6	11.0	7.1	10.2	8.5	7.2
Imports	15245	19038	15821	14349	11437	12095	14180	16213	17063	18261	19336
Change (%)	−3.4	24.9	−16.9	−9.3	−20.3	5.8	17.2	14.3	5.2	7.0	5.9
Net factor income from abroad	−1988	−4453	−6191	−4629	−3649	−4136	−2818	−2797	−2866	−2541	−1532
Gross national product (GNP)	39418	35065	31331	33772	37301	37377	39413	40221	41116	42445	44456
change (%)	1.5	−11.0	−10.6	7.8	10.4	0.2	5.4	2.1	2.2	3.2	4.7
Nominal GDP (mill curr col)	41406	57104	97505	126338	151681	175597	201501	232143	266779	305068	349914
change (%)	•	37.9	70.7	29.6	20.1	15.8	14.8	15.2	14.9	14.4	14.7
Per-capita GDP (colones)	18443	17404	16143	16145	16829	166677	16592	16537	16552	16582	16594
change (%)	−2.6	−5.6	−7.2	0.0	4.2	−0.9	−0.5	−0.3	0.1	0.2	0.1
Per-capita GNP (colones)	17558	15443	13480	14198	15329	15015	15485	15462	15473	15645	16042
change (%)	4.5	−12.0	−12.7	5.3	8.0	−2.1	3.1	−0.1	0.1	1.1	2.5
Per-capita consumption (col)	15449	13207	11687	12361	13303	12684	12629	12688	12292	12151	11960
change (%)	15.4	−14.5	−11.5	5.8	7.6	−4.6	−0.4	0.5	−3.1	−1.1	−1.6

Table I.2 Forecast for Costa Rica/October 1985 Baseline

In Millions of Nominal U S Dollars

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1999	1990
Summary											
Trade account balance	−374	−88	64	−45	−39	−40	−9	−20	12	35	57
Merchandise exports	10001	1003	869	853	956	929	1042	1111	1228	1337	1429
change (%)		0 2	−13 3	−1 9	12 1	−2 8	12 2	6 6	10 6	8 8	6 9
Merchandise imports	1375	1091	805	898	995	969	1051	1131	1216	1301	1373
change (%)		−20 7	−26 2	11 5	10 9	−2 6	8 4	7 6	7 5	7 0	5 5
Service & income credits	218	197	274	320	315	348	398	469	559	661	781
Service & income debits	522	545	641	628	627	660	627	675	747	799	886
Net transfers	14	27	36	69	133	137	138	140	142	145	149
Current account balance	−664	−409	−267	−284	−218	−215	−100	−86	−34	43	101
Gross debt (end year)	2397	2971	3269	4182	4162	4616	4672	4703	4647	4517	4238
Short term	520	506	508	491	462	460	526	565	608	651	686
Medium and long term	1878	2465	2762	3692	3700	4155	4146	4137	4039	3867	3552
Reserves (end year)	146	131	226	311	405	364	350	377	355	380	343
Changes in reserves		−14	95	85	94	−41	−13	27	−22	25	−36
Net debt (end year)	2252	2839	3043	3871	3757	4252	4321	4326	4292	4138	3895
Net new borrowing		−93	−256	−227	−388	362	−45	−24	−130	−164	−289
Gross financial requirements		493	288	392	2618	1456	961	1097	1315	1354	1377
Servicing of M&LT debt	247	214	144	650	2903	948	721	785	1066	1069	1106
Interest payments	147	133	108	521	359	315	241	230	229	201	127
Principal repayments	101	81	37	129	2544	633	480	555	837	868	979
Debt service/export (%)	24 7	21 3	16 6	76 2	303 6	102 1	69 2	70 7	86 8	80 0	77 4
Gross debt/export (%)	239 5	296 3	376 2	490 6	435 4	496 8	448 4	423 4	378 3	338 0	296 5
Interest/exports	14 7	13 3	12 4	61 2	37 5	33 9	23 2	20 7	18 7	15 1	8 9

Comments From the Office of Management and Budget

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D C 20503

MAY 12 1986

Mr. William J. Anderson
Director, General Government Division
U.S. General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Anderson:

This is the Office of Management and Budget response to your request for comments on the General Accounting Office draft report entitled "U.S. Use of Conditions to Achieve Economic Reforms" (GAO assignment Code 472063).

The OMB generally concurs with the report's findings. The report is largely descriptive of how the Agency for International Development (AID) has sought to condition balance of payments foreign assistance on economic policy reforms in recipient countries and the success of this approach in each of four representative countries. There are, however, several comments and conclusions in the report that merit attention:

o In the section on "AID Strategy and Factors Which Impact Upon It," GAO notes that: "the uncertainty of sustained growth in the industrialized countries, including the United States...casts doubt over the four case-study countries' growth prospects."

  OMB notes that any development strategy pursued by AID must operate upon certain assumptions concerning exogenous factors. Given the economic growth record among industrialized countries and current favorable conditions, sustained growth appears to be a reasonable assumption.

o In several places the draft report notes that AID's development strategy and projections are based on optimistic assumptions that, if not fulfilled, will necessitate higher levels of U.S. assistance in the future in order to accomplish the U.S. objective of promoting self-sustaining growth for the countries. The report states that it is uncertain whether AID's development strategy will work.

2

OMB notes that there is general agreement among executive agencies on AID's strategy of conditioning assistance on economic reform and pursuing an export growth strategy. While this strategy may not succeed in reducing future assistance requirements if external conditions worsen, alternative strategies are likely to result in still higher future U.S. assistance requirements.

o In the introduction to Chapter 4 and the "Conclusions" section it is noted that AID's use of conditions on assistance, while relatively successful in achieving stabilization, did so at a cost of contributing to increased debt-servicing requirements.

We would note that the alternative of no conditions on assistance would probably have resulted in lower economic growth and consumption, and similar levels of debt or the possibility of the countries going into default.

The Office of Management and Budget appreciates the opportunity to comment on the draft report.

Sincerely,

Philip A. DuSault
Acting Associate Director for
National Security and
International Affairs

Comments From the Agency for International Development

Note GAO comments supplementing those in the report text appear at the end of this appendix

AGENCY FOR INTERNATIONAL DEVELOPMENT
WASHINGTON D C 20523

May 20, 1986

ASSISTANT ADMINISTRATOR

MEMORANDUM

TO: Frank C. Conahan, Director
National Security and International Affairs Division
General Accounting Office

FROM: A-AA/PPC, Allison B. Herrick ABH

SUBJECT: GAO Draft Report, "U.S. Use of Conditions in Foreign Assistance to Achieve Economic Reforms" (472063)

We concur with the broad findings of the report, which show that policy conditionality can play an important role in bringing about economic stabilization and recovery. Nevertheless, we believe that there are five areas where the draft report draws overstated or misleading conclusions. These are discussed below. In addition, we have provided a number of specific comments and clarifications.

See p 3

1. U.S. strategy embracing stabilization and structural reforms. The report correctly emphasizes the extent to which U.S. policy concerns overlap those of the IMF in developing countries. In its case studies, the report carefully and amply surveys the wide range of U.S. bilateral conditions designed to promote both stabilization corrections and structural adjustments to promote long-term development. However, the "Executive Summary," understates the importance of conditionality directed at structural reform. This understatement could be corrected by replacing the first two sentences of the "Background" section of the "Executive Summary" with the following language, "To adapt to the changing circumstances of the world economy and to overcome the problems created by their own economic policy errors, the four surveyed countries, like many other countries receiving U.S. economic assistance, have required both stabilization and structural reforms. The United States has helped the four surveyed countries by providing economic resources and by encouraging reforms, both structural, of the kind also supported by the World Bank, and stabilizing, of the kind also supported by the International Monetary Fund." Additional suggestions on this topic are included below in the final section of "Specific Comments."

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Now on p 22

2. Causes of economic problems in recipient countries. The report's section, "Economic Problems in Recipient Countries," pp. 31 ff., begins with the important assertion that, "The economic problems in these countries are not just passing phenomena . . ." but the rest of the paragraph falls short as a description of the relative causal weights of external factors and of domestic policy errors and of the differences between the decade of the 1970s and the first years of the 1980s. The text is misleading i) in attributing inappropriate policies only to "response to negative external influences," ii) when citing petroleum price increases as among "short-term external circumstances," and iii) by attributing the observed problems to the accumulating unfavorable effects of "long-term structural trends" that are not defined. The subsequent text is clear and straightforward. Its content would be better introduced by an initial paragraph making four points. First, inappropriate economic policies were introduced over several decades. Their unfavorable effects accumulated for years. Second, the two petroleum price increases imposed immediate cost burdens extending over a medium term of a dozen years, and contributed, through policy errors, to excessive additions to foreign debt. Third, except for the large injuries inflicted by the Organization of Petroleum Exporting Countries, developments in the international economy were not unfavorable to these four countries. During 1970-1982 merchandise imports grew 4.3% a year in industrial market economies and 7.4% a year in upper middle income countries during the 1970s. That growth provided favorable trading opportunities for these four countries and for other LDCs. Except for iron ore, and bananas, the prices of the commodities traditionally exported by these four performed well during the 1970s. (Comparing the five-year averages of 1978-1982 with those of 1968-1972, industrial countries' export prices rose 170% while rubber prices rose just a bit more. Lagging, banana prices rose 130% and iron ore prices rose only 80%. But coffee prices rose 230%, bauxite prices rose 300%, U.S. sugar import prices rose 160%, and world sugar prices rose 240% over this interval.) Fourth, the 1970s decade of growing international trade and rapidly growing foreign debt was followed by several years of severe decline in the export markets of the four. This decline, along with the debt servicing burdens and the multitude of inappropriate economic policies inherited from the 1970s brought the balance-of-payments crises of the 1980s.

3. Jamaica's policy performance. We agree that Jamaica's macroeconomic performance has been disappointing compared to Costa Rica or the Dominican Republic, and that policy dialogue progress was not satisfactory during the first several years of our assistance. Nevertheless, very important policy reforms were in fact implemented beginning in the second half of 1983, including movement to a free-market exchange rate system, tax reform, elimination of the monopoly power of state marketing boards for several crops, and

have been registered as a result. The weak overall performance of the Jamaican economy since then has been due to severely adverse trends in the world market for Jamaica's major traditional export, bauxite. Without the substantial policy reforms taken over the past three years, Jamaica's economy would be in substantially worse shape today. More specific details on this issue are included in the specific comments.

4. Influence of external factors. The report makes much of the fact that the success of an export-oriented strategy will depend on "market variables and other external factors over which each country has little control." We would agree that the world economic situation, and factors, such as protectionism, that the developing country cannot control, are important, particularly in the short run. Nevertheless, we do not believe that this in any way vitiates the need for a greater export orientation by the countries in question. Reliance on import substitution has created serious structural inefficiencies in these countries, and a return to greater reliance on comparative advantage (i.e., on exports of labor-intensive products rather than import substitution of capital-intensive ones) would promote more efficient resource allocation and overall economic development.

5. Export Optimism. The draft report characterizes the A.I.D. strategy for export-led growth as requiring very optimistic assumptions for its success, and implies that the strategy is unlikely to work in practice. The report does not suggest any alternative strategy that is considered more promising.

The report provides no data on actual progress of the export strategy on which the extent of optimism could be judged. In fact, A.I.D.'s expectations for export growth for each of the three countries were exceeded by a wide margin during the two years of operation of the Caribbean Basin Initiative. We had anticipated that nontraditional exports to the U.S. market could grow at annual rate of 18-19% per year. This rate of growth would lead to manufactured exports to the U.S. exceeding traditional exports by 1990.

Table I summarizes actual trends in exports to the U.S. of such products. Each country's actual performance exceeded this growth rate in each year. For the three countries combined, the increase was 71% between 1983 and 1985--clearly an impressive performance, and substantially above our expectation of 40% growth. While much of this increase came from assembly operations, so that the U.S. import value substantially exceeds the value added by the exporting country, the figures strongly suggest considerable potential for non-traditional exports. In sum, the characterization of the strategy as optimistic is unwarrented by actual performance.

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Specific Comments and Clarifications

1. Since the Fund would not be able to assist a country with a debt problem (perhaps due to inadequate government revenues) but with no great balance-of-payments problem, the first paragraph of the "Background" section of the "Executive Summary" should read, "Fund programs are of critical importance to countries with persistent balance-of-payments difficulties because Fund resources provide support during the time required for stabilization reforms to produce their intended benefits. When assisted countries also suffer severe debt problems, Fund programs can be of critical importance because foreign debt generally . . . "

2. The Kemp-Kasten amendment does not mention the Fund by name. The penultimate sentence of the "Background" section should end, ". . . Congress restricted the linkage of U.S. assistance to recipient country compliance with 'the policies of any multilateral institution.'"

3. As the report's case studies show, U.S. bilateral conditionality has been tailored toward individual country circumstances in both stabilization and structural adjustment reforms. The "Results in Brief" section of the "Executive Summary" associates such tailoring only with structural reforms. The paragraph would be more accurate written, ". . . economic realignment of developing-country economies. In every case, the United States attempts to tailor its conditionality provisions to conform with the special circumstances of the particular country."

4. As the report's case studies make clear, compliance depends to a significant degree upon factors other than those cited in the sentence following the one proposed for amendment in "3" above. The incompleteness of the report's list might be acknowledged by an added "etc.," or the list might be lengthened to include such factors as the host government's commitment to the reforms, the strength of the institutions charged with implementation, and terms of and access to external financing (the latter to go beyond the narrow" interest rate" consideration of the report).

5. The report shows that some reforms were undertaken in each of the cases studied. The second paragraph of the "Results in Brief" section of the "Executive Summary" would be more accurate if it read, ". . . as to the timeliness of reforms and the degree to which each prescribed reform was implemented."

6. The United States supported structural reforms to improve each country's export base for reasons embracing but going beyond servicing external debt. The first sentence, third paragraph, of "Results in Brief" would be more accurate by asserting, ". . . improvement in each country's export base to obtain all the static

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and dynamic advantages of comparative advantage production as a means to promote economic development."

Now on p 13

7. The list of major policy areas in A.I.D. conditionality (page 18) should include "exchange-rate policy reforms to encourage exports, eliminate incentives for smuggling and capital flight, and remove other distortions that allocate resources inefficiently."

Now on p 15

8. First line, p. 21, standby arrangements are the principal means.

Now on p 15

9. The major role of the International Monetary Fund (IMF) (footnote 3 on page 21) is not to facilitate the expansion of world trade but to assist countries in correcting disequilibria in the current account of their balance of payments. The international organization primarily responsible for trade expansion is the General Agreement on Tariffs and Trade (GATT).

Now on p 23

10. The last two lines of the paragraph atop p. 32 should end, ". . . finances, and ability to service foreign debt."

Now on p 39
See comment 1

11. With respect to Table 4.4 (page 59), the major discrepancy is due to the fact that U.S. import data include the value of goods assembled overseas under 806/807 programs or other operations in free zones, while exporting countries do not count such products as merchandise exports. Only the value added in assembly is included in the exporting country's statistics, and this appears in the balance of payments as a <u>service</u> export.

Now on p 42

12. Unemployment rates for Latin American countries (page 64) can be very misleading because they do not mean the same thing as in the United States. The Jamaica figures, for example, include a large number of persons who are not actually seeking work and would be considered out of the labor force under U.S. definitions. Unemployment rates for the Dominican Republic, which suffer from some of the same deficiencies, are more typically reported in the 20-25 percent range and apply to Santo Domingo only; for the country as a whole, unemployment rates are lower.

Now on p 24
See comment 2

13. The paragraph overlapping pp. 34-35 cites "rescheduling of foreign debts" as among usual A.I.D. conditions. Rescheduling obviously helps debtor countries but has never been a U.S. condition.

Now on p 24

14. The assertion near the top of p. 35 that "there was no World Bank SAL in the Dominican Republic" may imply that SALs were in effect in Liberia and in Costa Rica, as well as in Jamaica, during the years being considered. That implication should be avoided.

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Now on p 25
See comment 3

15. The reported increase in Costa Rica's external debt from $3.0 billion in 1980 to $3.9 billion in 1984 (page 36) is misleading. Much of this increase represents recognition of principal and interest payments due in 1980-82 that had accumulated as arrears. These obligations, due to actions during 1980-82, were only recognized as debt in 1983. There was also an increase in long-term, concessional borrowing from A.I.D. and international agencies. There was very little new borrowing from private banks on commercial terms.

See comment 4

16. Regarding the issue of export taxes in the Dominican Republic, the report should note that these taxes have subsequently been reduced, and the USAID Mission is seeking their complete removal. The taxes were imposed as a temporary measures at the time of exchange rate unification in January 1985 to capture windfall gains to exporters in order to finance large Central Bank losses resulting from unification. The Mission made elimination of the taxes on non-traditional exports and reduction of the taxes on traditional exports conditions for disbursement of FY 1986 ESF. The taxes on non-traditional exports were eliminated, and the 36% exchange tax on traditional exports has been reduced to 18%. The Mission is now seeking removal of the 18% tax, which the Dominican government is considering.

Now on p 10

17. It is true that as of April 1983, A.I.D. had had limited success in using balance-of-payments funds as a tool to influence policy reforms in Jamaica (page 11). However, since then, A.I.D. has had very substantial success. The reforms undertaken by the Government of Jamaica include:

- Unification of the exchange rate in November 1983. In U.S. dollar terms, net depreciation to date has been 67%. As a result, a number of new export products have appeared in Jamaica. Although far less than losses from the decline in bauxite exports, these new exports are making a significant contribution to Jamaica's economy.

- Tax reform. The personal income tax has been simplified at a single, low rate. Business and other taxes are also being revised.

- Cuts in public sector employment. Courageous, politically difficult measures have been taken to reduce the size and scope of government. By the end of 1985, over 12,000 public sector workforce positions had been eliminated, and the Central Government's overall budget deficit was reduced from an average 15% of GDP during 1980-83 to 5%. Twelve public sector enterprises had been privatized by the end of 1985, and an additional 32 were in some stage of being divested or privatized.

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- Import quotas. The import quota system has been substantially abandoned and licensing requirements reduced. Whereas in 1980 all imports required licenses and 364 tariff items were subject to quantitative limits, by the end of 1985 only 76 items remained subject to quantitative restrictions and only 160 remained subject to licensing.

- Export monopolies. Export marketing of coffee and bananas has been substantially deregulated. Partially as a result, banana export volume and quality are substantially increasing, with further expansion now in progress. Coffee acreage and exports are also increasing.

- Price controls. The number of items subject to price controls has been reduced from 60 to three (although percentage mark-ups on certain basic commodities remain in effect).

Now on p 30

18. The second sentence of the paragraph beginning on the bottom of p. 45 needs amplification or clarification. "Mechanism to effect" and "'trade'in exchange" are not clearly distinct.

Clearance:
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TABLE I

U.S. IMPORTS FROM SELECTED COUNTRIES, 1983-85
MANUFACTURES AND NON-TRADITIONAL FRUITS AND VEGETABLES
($ million)

Exporting Country	1983	1984	1985	Percentage increase 1983-1985
Costa Rica	111.3	145.2	178.5	60.4%
Dom. Republic	290.8	387.8	460.7	58.4%
Jamaica	23.5	41.5	90.1	283.4%
TOTAL	$425.6	$574.5	$729.3	71.4%

NON-TRADITIONAL FRUITS AND VEGETABLES
($ million)

Exporting Country	1983	1984	1985	Percentage increase 1983-1985
Costa Rica	8.9	10.8	12.0	34.8%
Dom. Republic	31.1	36.2	39.4	26.7%
Jamaica	3.8	7.3	11.4	200.0%
TOTAL	$43.4	$54.3	$62.8	43.4%

MANUFACTURED GOODS
($ million)

Exporting Country	1983	1984	1985	Percentage increase 1983-1985
Costa Rica	102.4	134.4	166.5	62.6%
Dom. Republic	259.7	351.6	421.3	62.2%
Jamaica	19.7	34.2	78.7	299.5%
TOTAL	$381.8	$520.2	$666.7	74.6%

Source: U.S. Department of Commerce. Manufactured goods are all commodities in Schedule A groups 5-8; non-traditional fruits and vegetables are Schedule A group 05, excluding bananas.

AID's major comments have been incorporated in the text where appropriate. The following are our comments on other points made by AID in its May 20, 1986, letter.

GAO Comments

1. Following receipt of AID's comments, we talked with an official of the Dominican Republic's Central Bank. The official said that the process AID described does not exist and that the discrepancy is due to under-invoicing by Dominican exporters in order to avoid export taxes.

2. We have changed the text. However, while debt rescheduling may not be a usual AID condition, it was a 1985 condition for the AID program in the Dominican Republic.

3. The numbers on Costa Rican debt have been updated. The increase in debt is not attributable to principal accumulated as arrearages since principal is always classified as debt. Interest accumulated as arrears is a "debt owed" but is not classified as debt unless the country has undertaken new borrowing to pay off the interest arrearage. In 1983, the Costa Rican government assumed responsibility for previously non-guaranteed private debt, but our figures on Costa Rican debt already included private debt statistics. AID is correct that commercial borrowing has declined, but concessional borrowing has not compensated for the decline and in fact the increase has been minimal—from 14.3 percent of publicly-guaranteed debt in 1980 to 16.6 percent in 1984.

4. We have recognized in the text the Dominican Republic's reduction/elimination of export taxes.

Comments From the Department of the Treasury

DEPARTMENT OF THE TREASURY
WASHINGTON

May 21, 1986

Dear Mr. Conahan:

Thank you for the opportunity to comment on your draft GAO report entitled, U.S. Use of Conditions in Foreign Assistance to Achieve Economic Reforms. The Report's principal finding concerning debt reschedulings is misleading. As drafted on page 2, one could make the presumption that decisions on debt relief are predicated on AID's country objectives. This is not true. U.S. Government debt policy is outlined in the 1978 NAC decision on administration policy regarding rescheduling.

Another important point we would like to call to your attention concerns the IMF. In discussing IMF conditionality, your analyses should consider what the state of the recipient's economy would have been without Fund intervention. Difficult adjustment measures, supported by the IMF, are an alternative to further economic decline and hardship. Better balance should be sought in your discussion of this important issue.

As you will see from the enclosed "marked-up" copy, our additional comments are numerous. In some cases we have made specific suggestions and in others we have merely flagged sections that could be strengthened by examples or where institutional linkages or concepts are not clear. We are prepared to discuss these comments with you as you deem appropriate.

Sincerely,

Matthew P. Hennesey
Acting Deputy Assistant Secretary
Developing Nations

Mr. Frank C. Conahan
Director
U.S. General Accounting Office
Washington, D.C. 20548

Enclosure

Glossary

Balance of Payments	The measure of a nation's total receipts from and total payments to the rest of the world.
Current Account Balance	The difference between exports and imports of goods and services, minus net transfer payments made to foreigners.
Debt Service Ratio	The total principal and interest due to foreign lenders in a year, divided by that year's exports of goods and services, and expressed as a percentage. The larger the ratio, the more difficult it is for the country to service its external debts.
Devaluation	A decrease in the value of a country's currency relative to other countries' currencies
Exchange Controls	Government restrictions on the legal ability to convert a country's currency into other currencies.
Export-Oriented Industrialization	The policy of industrialization pursued by some developing countries which involves increasing the output of manufactured goods for export.
Import-Substitution Industrialization	The policy of pursuing industrialization through the replacement of imports with domestically-produced manufactures, and involving the setting of high import barriers to protect new industries.
Gross Domestic Product	GDP measures the total final output of goods and services produced by an economy regardless of allocation to domestic and foreign claims, and calculated without making deductions for depreciation.
Macroeconomics	The branch of economics dealing with the performance of aggregate economic variables, such as the total receipts and payments of a country and the general price index.

Multiple Exchange Rates	The different exchange rates often enforced by developing countries for each class of imports/exports depending on the usefulness of the various imports/exports as determined by the government.
Stabilization Program	Policies that are designed to lead to short-term internal (employment and inflation targets) and external (equilibrium in international payments) balance, such as the adjustment of the exchange rate.
Structural Adjustment	Policies that lead to long-term internal and external balance, such as divestiture of unprofitable public-sector enterprises.

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