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REPORT BY THE

Comptroller General

OF THE UNITED STATES

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Providing Effective Economic Assistance To El Salvador And Honduras: A Formidable Task

Substantial increases in funding of Agency for International Development (AID) programs raised economic assistance totals for 1984 and 1985 to $636 million for El Salvador and $305 million for Honduras. The effectiveness of this assistance will depend largely on fundamental economic policy reforms.

AID and the Department of State planned to use U.S. balance-of-payments assistance to influence policy changes necessary for economic stability, but the governments of El Salvador and Honduras have been reluctant to implement key policy reforms. Because of U.S. security and political objectives, the United States has not required that reforms be made before providing continued assistance. There is a divergence of views among federal agencies as to the priority of economic reforms. GAO believes it would be advantageous for federal agencies to seek more agreement on the degree to which economic assistance should be used to influence economic reforms in El Salvador and Honduras. GAO also believes, because of uncertainties as to congressional support for macroeconomic reform efforts, that the Congress should provide an explicit statement of the importance it attaches to improved economic policies in these countries.

GAO found that constraints commonly associated with AID project implementation exist in El Salvador and Honduras which could adversely affect host-country ability to sustain AID efforts. AID is using delivery techniques which lessen these difficulties in the short-term, thereby permitting timely provision of assistance.

GAO/NSIAD-85-82
JULY 3, 1985

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

B-218801

The Honorable Mark O. Hatfield
The Honorable Dennis DeConcini
The Honorable Daniel K. Inouye
The Honorable Patrick Leahy
United States Senate

Your letter of April 16, 1984, requested that we review U.S. military and economic assistance programs for El Salvador and Honduras. This report discusses U.S. economic assistance programs for the two countries and describes how assistance is being provided to overcome implementation problems and the difficulties experienced in influencing the two governments to undertake economic policy reforms. A report dealing with military assistance programs will be provided separately.

This report includes a recommendation to the Congress on page 45 to provide an explicit statement of the relative importance that it attaches to improved economic policies in El Salvador and Honduras. This report also includes recommendations to the Administrator, Agency for International Development, and the Secretary of State.

Milton J. Socolar

Acting Comptroller General
of the United States

COMPTROLLER GENERAL'S REPORT

PROVIDING EFFECTIVE ECONOMIC ASSISTANCE TO EL SALVADOR AND HONDURAS: A FORMIDABLE TASK

D I G E S T

Economic assistance to El Salvador and Honduras has increased rapidly in the 1980's, reflecting the importance the administration attaches to achieving economic improvement in these two Central American countries. For 1984 and 1985, economic assistance to El Salvador and Honduras will total almost $1 billion. The Agency for International Development (AID) and the Department of State expect to continue providing substantial assistance to both countries at least through 1989. These levels are consistent with recommendations made in January 1984 by the National Bipartisan Commission on Central America, which studied the economic, social, and political conditions throughout Central America and their potential ramifications for U.S. security interests.

In response to a request by Senators Hatfield, DeConcini, Inouye, and Leahy, GAO reviewed U.S. economic assistance programs in El Salvador and Honduras to determine (1) whether this assistance could be absorbed and administered effectively and (2) whether the United States has been able to influence these countries to undertake economic policy reforms to promote long-term stabilization and growth.

ABILITY TO ADMINISTER EXPANDING ASSISTANCE PROGRAMS

For 1984 and 1985, U.S. economic assistance will total $636 million for El Salvador and $305 million for Honduras. GAO found that AID has chosen assistance delivery techniques which permit quick disbursement of this assistance and minimize management burden.

--Over half of the 1984 and 1985 assistance is in the form of cash transfers for balance-of-payments support, which require relatively little management time to oversee and can be disbursed quickly.

--Concessional food sales, which are also relatively easy to administer, account for

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an additional 13 percent of the assistance programs.

--Development project assistance has been designed to minimize implementation delays common to this form of assistance, so expenditures have generally kept pace with the level of obligations. (See pp. 7 to 10.)

AID has been emphasizing quick disbursing assistance in El Salvador since about 1980, whereas in Honduras the emphasis on quick disbursing assistance began just prior to fiscal year 1983. As a result, AID believes that, for the most part, it should be able to administer its expanding programs without serious implementation delays.

Traditionally, AID's development assistance projects emphasize long-term training and technical assistance to strengthen host-country capacity to administer programs. However, in El Salvador, development assistance projects have emphasized public works construction, employment, and commodity procurement needed to improve economic conditions in the short term. AID has funded relatively few activities to improve El Salvador's institutional capability to manage development activities. AID officials said that increased emphasis on institutional strengthening was a desirable goal but that El Salvador's short-term needs were so extensive that institution-strengthening was not currently a priority. In addition, institution-strengthening activities require extensive AID oversight and are difficult to implement quickly. (See pp. 15 and 16.)

In Honduras, development projects have emphasized institution-building. However, Honduran government institutions have a limited capacity to absorb technical assistance and to administer projects; therefore AID plans to place increasing reliance on private sector entities to carry out project activities and to devote more assistance to fast-disbursing construction activities similar to those in El Salvador. (See pp. 16 to 18.)

Although AID is providing assistance in forms that minimize implementation difficulties, AID does fund development projects and encounters implementation problems with them that are commonly associated with project assistance.

The governments of El Salvador and Honduras lack institutional expertise to effectively administer large and complex projects and funds to finance their share of project costs; also they may not be able to fund recurring costs in the future, such as maintenance of completed projects, unless overall economic conditions improve. (See pp. 18 to 21.)

AID INFLUENCE ON POLICY CHANGE LESS THAN PLANNED

The effectiveness of economic assistance in El Salvador and Honduras depends largely on fundamental economic reforms. AID and the Department of State, in requests to the Congress for appropriations, said that balance-of-payments assistance would be linked to implementation of needed economic policy reform. AID and the Department of State planned to use balance-of-payments assistance to influence the governments of El Salvador and Honduras to adopt economic adjustment policies to correct fiscal and foreign exchange imbalances and encourage production and exports, thereby lessening the need for external assistance to finance imports.

AID believes that adjustments within the foreign exchange systems with eventual unification of official and parallel[1] exchange rates are measures which in conjunction with fiscal and monetary actions are key to fostering export competitiveness needed for economic recovery. AID also believes that establishment and maintenance of economic stabilization programs with the International Monetary Fund would increase the availability of external financing from sources other than the U.S. government, thereby lessening the need for U.S. assistance. According to AID, positive actions on the exchange rate issue will probably facilitate negotiation of Fund stabilization programs.

On these two important policy issues, AID and State have had only partial success in achieving economic policy goals reflected in planning documents and agreements. In association with U.S. balance-of-payments assistance, the government of El Salvador and, to a lesser extent, the government of Honduras have

[1]A rate which more closely represents the market rate.

taken some significant economic policy actions. For example, El Salvador, through use of a parallel market, has adjusted the exchange rate for 42 percent of its imports and exports. However, Honduras has not made significant exchange rate adjustments. The governments of El Salvador and particularly Honduras have been reluctant to adjust exchange rates of their currencies because this action would be politically unpopular as it would raise the cost of imported goods. Further, since late 1983, neither country has been able to negotiate and maintain International Monetary Fund arrangements.

From 1982 to 1984, AID disbursed $320 million to El Salvador in 11 cash transfers and $121 million to Honduras in 6 cash transfers. Each of these cash transfers presented opportunities to require implementation of policy reforms, but AID and the Department of State have not always taken advantage of these opportunities. GAO's analysis shows that AID and the Department of State have not always included desired reforms in assistance agreements as planned and have disbursed funds in several cases even though required policy actions by the governments have not been taken. (See pp. 30 to 36.)

AID has not been able to insist on more action because macroeconomic reform is not always the top U.S. priority, given the political and security objectives which place a premium on maintaining political stability. The Department of State believes political stability could be undermined by unpopular economic reforms. As a result, the United States provided assistance to both El Salvador and Honduras in the summer of 1984 without requiring policy changes which AID sought. AID had planned to withhold this assistance until the needed changes were made. (See pp. 39 and 40.)

AID had not made analyses of the future need for external balance-of-payments support if desired reforms do not occur. However, AID mission economists told GAO that, based on their rough estimates, Honduras may require up to $250 million in external balance-of-payments support in 1985 without exchange rate adjustments or a Fund arrangement. Presuming a continued U.S. interest in achieving economic stabilization and growth in Honduras and

El Salvador, meeting this need would involve significant future costs to the U.S. government. (See pp. 29 and 30.)

DEVELOPING A STRATEGY TO INFLUENCE POLICY CHANGE

There is a divergence of views within the U.S. government as to the priority of economic reforms. The Department of State has cautioned against rigidly requiring economic policy changes at the possible expense of U.S. political and security objectives. State officials told GAO that in hindsight AID's plans to influence reforms have been optimistic and perhaps unrealistic given the political situation. In contrast, the Department of the Treasury and the Office of Management and Budget have advised AID to more forcefully advocate policy changes as conditions of balance-of-payments assistance.

Congressional support for linking U.S. balance-of-payments assistance to economic reforms is, in AID's opinion, not clear. AID told GAO that legislation which prohibits restricting assistance solely as a result of the policies of multilateral institutions (such as the International Monetary Fund) had been interpreted by some AID and recipient country officials as an absence of congressional support for linking balance-of-payments assistance to economic reforms. Further, AID mission officials said they were unaware of explicit statements of congressional views on the importance of economic reforms. (See pp. 40 and 41.)

CONCLUSIONS

The divergence of U.S. agency views has contributed to AID's uncertainty as to how forcefully it should advocate economic reforms. GAO believes there is a need for more agreement on the degree to which U.S. balance-of-payments support should be used to bring about economic policy changes in El Salvador and Honduras. With more agreement, AID and the Department of State should, in their requests for appropriations, be able to more realistically describe what reforms can be influenced. AID sees three basic alternatives.

1. Withhold disbursements until desired policy changes occur. This might maximize AID's leverage over economic policies but might also jeopardize overall U.S. objectives.

2. Provide balance-of-payments support without attaching economic conditions. This would meet short-term political interests but could result in increasing dependence on high levels of U.S. balance-of-payments support.

3. Condition assistance on economic reforms within the context of U.S. political and security objectives. This would involve balancing U.S. economic, political, and security interests. (See pp. 41 and 42.)

GAO recognizes the sensitivity of U.S. objectives in Central America and that the United States has important objectives other than macroeconomic policy changes in El Salvador and Honduras. Forcing economic changes would be unwise if it caused politically destabilizing effects in the two countries. However, from an economic point of view, GAO believes it is difficult to justify U.S. financing of large-scale, balance-of-payments deficits in El Salvador and Honduras which are caused, in part, by inappropriate macroeconomic policies of these countries. Estimating the costs of future U.S. balance-of-payments support in the absence of economic policy reforms would permit a more fully informed discussion of the trade-offs involved.

Given the uncertainties on the extent of congressional support for macroeconomic reform efforts, GAO believes that the Congress should provide an explicit statement of the relative importance it attaches to improved economic policies in these countries.

RECOMMENDATIONS TO THE ADMINISTRATOR OF AID AND THE SECRETARY OF STATE

GAO recommends that the Administrator of AID, in consultation with the Secretary of State, prepare and present to the Congress a detailed analysis of the estimated costs to finance future balance-of-payments deficits in El Salvador and Honduras in the absence of additional macroeconomic reforms, particularly exchange rate adjustments.

GAO also recommends that the Secretary of State, in cooperation with the Administrator of AID, initiate interagency discussions to reach more agreement on the degree to which balance-of-payments assistance should be used to influence economic reforms in El Salvador and Honduras. These discussions should include the Department of the Treasury, the Office of Management and Budget, and other agencies, such as the Department of Defense, which have responsibility for U.S. programs in these countries. Results of these discussions should be presented to the Congress.

RECOMMENDATION TO THE CONGRESS

In view of the uncertainties on the extent of congressional support for macroeconomic reform efforts (stemming in part from the legislation which prohibits restricting AID assistance solely as a result of the policies of multilateral institutions), GAO recommends that the Congress provide an explicit statement of the relative importance it attaches to improved economic policies in these countries.

AGENCY COMMENTS AND GAO EVALUATION

AID, the Departments of State and the Treasury, and the Office of Management and Budget generally agreed with the report's conclusions and recommendations. (See apps. I to IV.)

On GAO's recommendation to the Congress on explicitly stating the degree of importance that it attaches to economic reform, State and AID both commented that any such statement should describe the emphasis to be placed on economic changes relative to other U.S. foreign policy objectives in these two countries.

Regarding GAO's recommendation to estimate future costs of financing balance-of-payments deficits, the State Department commented that this would be a useful input to administration policy makers. AID did not comment on this recommendation.

Regarding GAO's recommendation on reaching more interagency agreement on using assistance to bring about macroeconomic reforms, State said that there already was a consensus within the administration on the broad objectives of U.S. assistance and that the administration has undertaken measures to reach an interagency consensus on using cash transfer assistance to influence economic reforms. Therefore, State believes that additional action on this recommendation is not warranted.

Comments from the Treasury and the Office of Management and Budget, however, illustrate the diversity of views on this issue. The Department of the Treasury endorsed this recommendation and the Office of Management and Budget said that the consequences of postponing economic reforms could be as politically destabilizing as withholding aid disbursement. Given this diversity of views and the lack of data on the cost of financing future balance-of-payments deficits in the absence of reforms, GAO believes the recommendation to reach more interagency agreement is valid. Although GAO has not evaluated the adequacy of recent State actions to reach more interagency agreement, it believes that the results of the interagency discussions should be presented to the Congress. GAO's recommendation has been modified accordingly. AID did not comment on this recommendation.

Contents

ILLUSTRATIONS

ABBREVIATIONS

AID	Agency for International Development
ESF	Economic Support Fund
GAO	General Accounting Office
IMF	International Monetary Fund

CHAPTER 1

INTRODUCTION

In January 1984, the National Bipartisan Commission on Central America[1] recommended large increases in economic assistance to help countries in Central America achieve economic, political, and social stability. Consistent with this recommendation, the administration requested and the Congress made available supplemental fiscal year 1984 and fiscal year 1985 assistance totalling about $1.3 billion for Central America. About half of this additional assistance was for programs in El Salvador and Honduras. This report discusses U.S. economic assistance programs in these two countries.

INCREASED ECONOMIC ASSISTANCE

Economic assistance to El Salvador and Honduras has increased rapidly in the 1980's, reflecting the growing U.S. concern over economic and political instability in these countries and throughout Central America and desire to protect U.S. security interests so close to the U.S. southern border and the Panama Canal. Through regular appropriations and supplemental appropriations approved in 1982 as part of the administration's Caribbean Basin Initiative,[2] 1983 assistance levels reached $242 million in El Salvador, making it the fifth largest recipient of U.S. economic assistance in the world--behind Egypt, Israel, Turkey, and Pakistan. Assistance levels in Honduras reached $103 million in fiscal year 1983, making it the 11th largest recipient. Economic assistance for the two countries totalled $345 million in fiscal year 1983, or almost one third of the total economic assistance provided to Western Hemisphere countries.

In February 1984, the administration proposed $6.4 billion in economic assistance for Central America for fiscal years 1984-1989. This proposal was to implement recommendations of the National Bipartisan Commission on Central America, with El Salvador and Honduras as primary recipients of additional assistance. The administration justified its proposal on the basis that expanded economic assistance was needed to overcome severe economic conditions and to promote social justice and the democratic process. The administration believed that by improving economic, social, and political conditions, the United States

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[1]Also referred to as the Kissinger Commission. It was formed at the request of the President to study economic, political, and social conditions in Central America and their effect on U.S. security interests and to propose U.S. policies and programs to support U.S. interests.

[2]A package of trade and aid provisions to assist Central American and Caribbean countries' economies.

could counter Soviet influence in Central America. The increased economic assistance was to be accompanied by increased military assistance to the region.

In August 1984, the Congress passed supplemental appropriations and in October 1984, through a continuing resolution, made available fiscal year 1985 funds which, for the most part, provided the economic assistance funds requested for El Salvador and Honduras. This action, in addition to the regular 1984 appropriation, raises economic assistance totals for the 2-year period 1984 and 1985 to almost $1 billion--$636 million for El Salvador and $305 million for Honduras. The sharp increase in assistance to the two countries is illustrated in the graphs on page 3. After accounting for inflation, the assistance has grown between 1981 and 1985 at an average annual rate of 23 percent in El Salvador and 31 percent in Honduras.

The Agency for International Development (AID) is responsible for administering economic assistance programs and has field missions in both El Salvador and Honduras. Assistance levels, however, are determined through deliberations involving AID, the Departments of State and the Treasury, the Office of Management and Budget, and other agencies. Further, AID shares responsibility for policy direction with other agencies. The three major forms of assistance are:

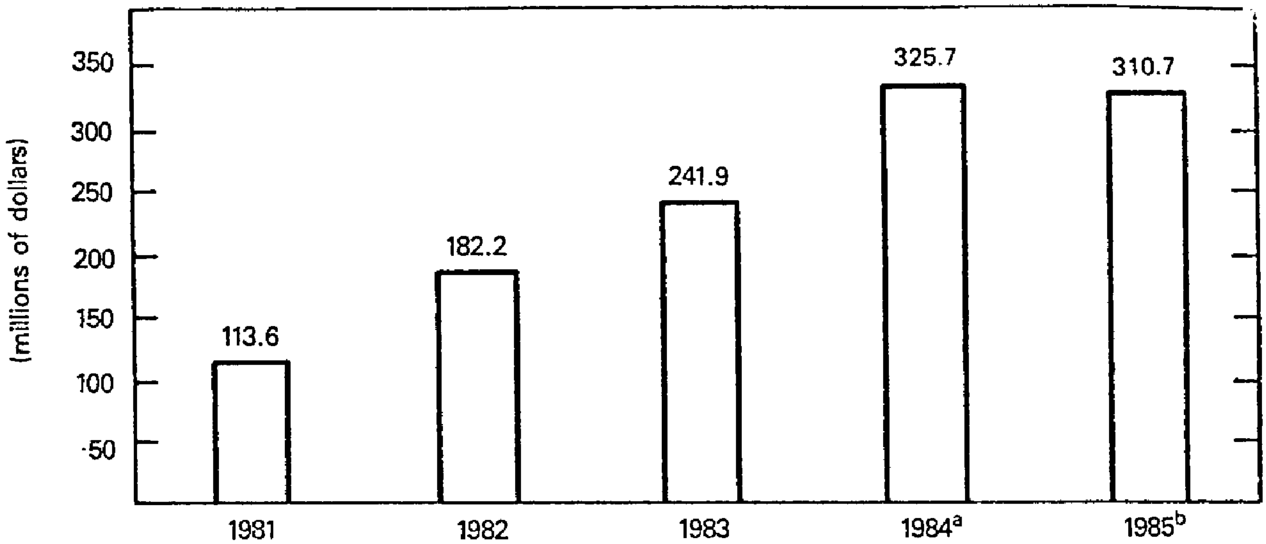
--The Economic Support Fund (ESF), which finances aid to promote economic or political stability where the United States has special strategic interests. The Department of State is responsible for policy direction and program justification, but AID administers the program.

--Development Assistance, which generally finances specific activities in agriculture, population, health, education, and other development sectors. AID is responsible for program direction.

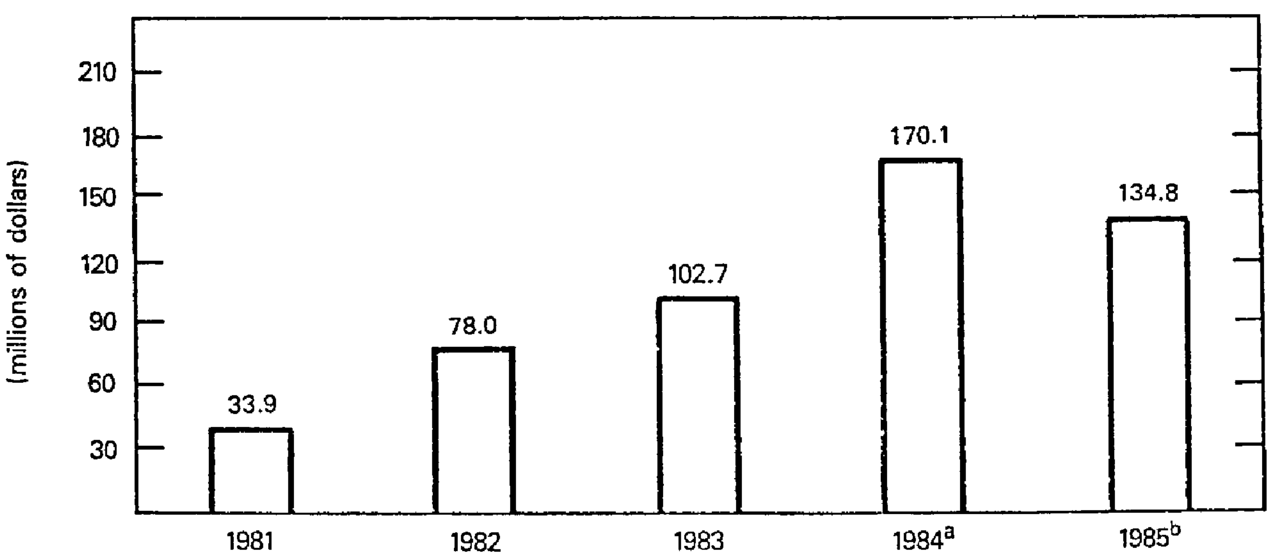
--Food assistance, which is provided under Public Law 480. The food programs subsidize food sales under Title I of the legislation and provide donations under Title II. The Departments of Agriculture, the Treasury, and State, and AID participate in formulating program direction.

AID programs in El Salvador and Honduras differ from typical AID programs because they are operating in a highly charged political environment, where the United States is supporting development of a democratic process--a process which is relatively new to both countries and vulnerable to radical political solutions. AID is supporting sensitive initiatives in El Salvador, including land and judicial reform, in an effort to

U.S. Economic Assistance to El Salvador



U.S. Economic Assistance to Honduras



[a] 1984 totals include supplemental assistance which must be obligated by March 1985.

[b] 1985 assistance was made available by a continuing resolution and does not include any supplemental appropriations which may be requested.

bolster the democratically elected government. The military conflict in El Salvador and the increased U.S. military assistance to both El Salvador and Honduras also contribute to the atypical nature of the AID programs in these countries.

COUNTRY BACKGROUND INFORMATION

The neighboring countries of El Salvador and Honduras are bordered on the north by Guatemala and on the south by Nicaragua. Both El Salvador and Honduras have democratically elected governments but historically have been ruled by the military. El Salvador is in the midst of a political crisis, with a guerrilla insurgency that has lasted over 5 years, leaving the country with serious political, social, and economic problems. The United States has been the primary supporter of El Salvador's effort to overcome the insurgency and bring about political and economic stability. Historically, Honduras has been the poorest country in Central America, but the great income disparities that have fueled social tensions in other Central American countries have been less of a problem. This relative social stability in Honduras and its location between El Salvador and Nicaragua has made it strategically important to the United States.

Both countries have a population of less than 5 million, but El Salvador, because of its small size, is much more densely populated. Their economies are based on agriculture, with coffee and sugar being among their principal exports. Selected social and economic data on both countries is presented below.

Selected Country Data

	El Salvador	Honduras
Population	4.9 million	4.2 million
Population growth rate	2.8 percent	3.4 percent
People per square mile	543	82
Per capita gross national product	$700	$660
Annual rate of inflation	10.8 percent	8.7 percent
Life expectancy	64 years	60 years

Source: AID's 1986 Congressional Presentation.

PRIOR GAO REPORTS

In a March 1984 report, U.S. Economic Assistance to Central America (GAO/NSIAD-84-71), we provided an overview of AID programs, describing how the cash transfer[3] method of assistance operated, and presented three issues for congressional consideration.

1. What are the Congress and the administration's expectations and objectives for cash transfer assistance; what degree of control is practical given these expectations and objectives?

2. What standards should AID set for controlling and monitoring local currencies?

3. Should AID increase its staff to increase oversight of the expanding programs?

In other reports, we reviewed selected development and humanitarian assistance activities in Central American countries, including Honduras and El Salvador; however, we have not previously issued reports focusing on AID's overall programs in these two countries.

OBJECTIVES, SCOPE, AND METHODOLOGY

We made this review at the request of Senators Mark O. Hatfield, Dennis DeConcini, Daniel K. Inouye, and Patrick Leahy, members of the Senate Committee on Appropriations, for additional information and observations on the status of current and planned economic assistance to El Salvador and Honduras. We were also asked to review U.S. military assistance activities in El Salvador and Honduras. These activities will be addressed in a separate report. Our review focused on two questions.

1. Can the recipient governments and the AID missions responsible for overseeing implementation of programs in these countries absorb and effectively administer the larger assistance programs?

2. Has the United States been able to influence the recipient governments to undertake needed macroeconomic policy reforms, particularly those reforms which AID described in Congressional Presentations and assistance agreements? As part of this question, we also

[3]Under the cash transfer form of assistance, U.S. dollars are transferred directly to a recipient government bank account where they are sold to importers requiring dollars in exchange for local currencies. The local currencies are generally used by the recipient government for agreed activities.

reviewed the relationship of AID policy influence to International Monetary Fund programs.

We performed fieldwork in Washington and at AID missions in El Salvador and Honduras during June to October 1984. We talked with AID and embassy officials, representatives of private sector organizations, host-government officials responsible for administering portions of AID's program, and selected ministers and top-level advisors involved in macroeconomic policy direction. We reviewed AID and State documents, such as project and program plans, progress reports, economic studies and analyses, evaluations, cables, and financial documents. We visited selected project sites to observe project impact and implementation difficulties. Site visits were selected for projects which were close to completion, large, and representative of each development sector, but visits were limited in some instances by security conditions. We also met with representatives from other bilateral and multilateral agencies, including the World Bank, the Inter-American Development Bank, and the International Monetary Fund, to get their viewpoints on the economic problems in El Salvador and Honduras.

In consultation with AID, we determined that reviews of disbursement rates, project delays, and extent of monitoring and control exercised would enable us to analyze how well the expanding assistance, in general, can be absorbed and effectively administered. We did not evaluate individual projects in detail nor review the ultimate use of AID's assistance.

To respond to the question concerning U.S. influence on macroeconomic policy reform, we compared public statements by AID and the Department of State, internal planning documents, and provisions of loan and grant agreements with recipient-government policy actions which had been implemented. We also met with officials from the Department of the Treasury and Office of Management and Budget to discuss their views on economic policy reforms in El Salvador and Honduras. We did not attempt to quantify a cause and effect relationship between AID's assistance and recipient government actions. Some action may have occurred independent of AID's program.

Because of the sensitivity of ongoing dialogue between the United States and the governments of El Salvador and Honduras, some of the information we obtained on macroeconomic policy reform is classified. We reviewed this information to obtain a full understanding of the events, complexities, and considerations involved.

Our review was made in accordance with generally accepted government auditing standards.

CHAPTER 2

ABILITY TO ADMINISTER EXPANDING ASSISTANCE PROGRAMS

U.S. economic assistance to El Salvador and Honduras for fiscal years 1984 and 1985 will total almost $1 billion. Most of this assistance will be in the forms of quick disbursing cash transfers and food sales which can be provided with relatively little AID or host-country staff oversight. Project assistance, which requires more staff oversight, has to a large extent been designed to be quick disbursing and avoid project delays. AID's provision of quick disbursing assistance in El Salvador represents a continuation of program focus since about 1980, whereas in Honduras emphasis on quick disbursing assistance began just prior to fiscal year 1983. As a result, AID believes that, for the most part, it should be able to administer its expanding programs while minimizing implementation delays. Nevertheless, in the development assistance area, AID faces constraints such as host-country institutional weaknesses and insufficient resources and, in El Salvador, staff shortages. These constraints could affect future program effectiveness.

DELIVERY TECHNIQUES SPEED DISBURSEMENT

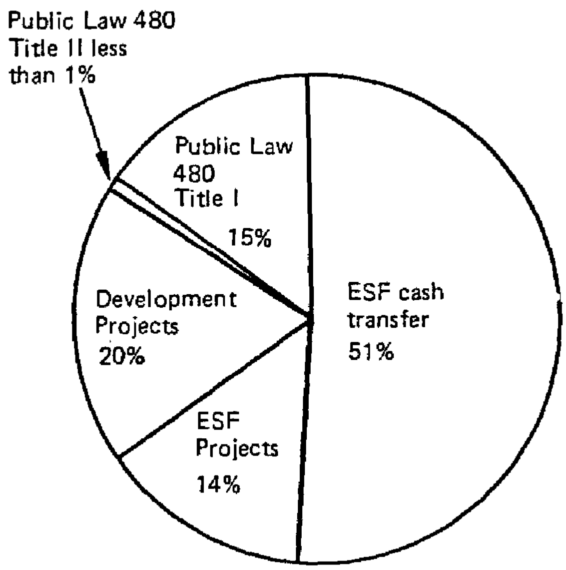
U.S. economic assistance to El Salvador and Honduras is intended to provide balance-of-payments support, achieve specific development and humanitarian goals, and encourage social and economic changes. Our analyses of program composition in both countries shows that the majority of assistance made available in fiscal year 1984 regular and supplemental appropriations was designed to provide short-term, balance-of-payments relief. Assistance planned for 1985 also emphasizes balance-of-payments relief.

Almost one-half of the assistance made available to both countries in regular 1984 appropriations ($140 million) was for balance-of-payments support in the form of cash transfers. Supplemental 1984 assistance appropriated in August 1984 was even more heavily weighted toward the cash transfer form of assistance. By providing cash transfers, AID is able to infuse balance-of-payments assistance quickly to the two countries to help meet their immediate needs for foreign exchange. AID plans to spend almost half of its 1985 program for cash transfers. Concessional food sales under Public Law 480 provide long-term, low-interest financing--an additional form of balance-of-payments relief. Like cash transfers, the food sales are a fast disbursing form of assistance.

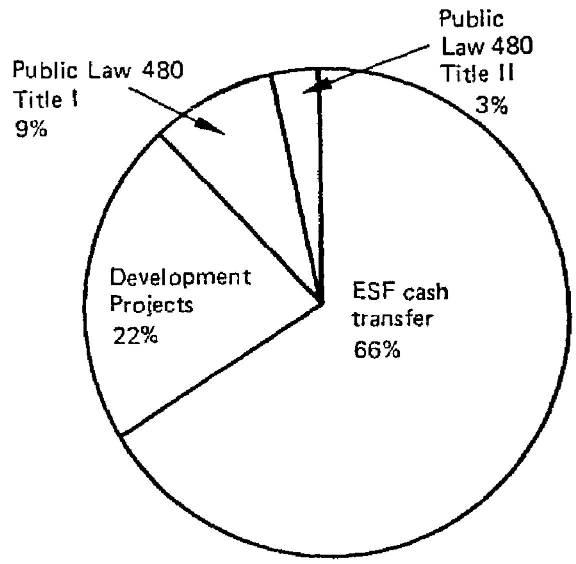
From 1983 to 1985, development project assistance levels have increased by 19 percent in El Salvador and 33 percent in Honduras. Much of this increase is for projects which emphasize procurement of commodities, construction of physical infrastructure and provision of jobs and credit. AID is minimizing delays by not designing projects with a heavy emphasis on strengthening host-country institutions--projects which generally take longer to implement and often encounter implementation difficulties. By structuring its project assistance in this way, AID is providing large amounts of project assistance more rapidly.

Uses of 1984 Economic Assistance Including Supplemental Funds

El Salvador



Honduras



	(millions)
ESF cash transfer	$165.0
ESF projects	45.2
Development projects	64.4
Public Law 480 Title I	49.0
Title II	2.1
Total	$325.7

	(millions)
ESF cash transfer	$112.5
Development projects	38.3
Public Law 480 Title I	15.0
Title II	4.3
Total	$170.1

We analyzed AID data on development project assistance obligations and expenditure rates and found that expenditures were generally keeping pace with increased obligations, as shown in the graphs on page 10. According to AID officials, an assistance pipeline--the amount of assistance obligated but not spent--may indicate implementation delays if it exceeds, by a factor of two, AID's annual development assistance level for a given country. This is because AID obligates funds well in advance of planned expenditures, often committing funds for expenses several years into the future. In El Salvador, the development assistance pipeline as of September 1984 was only about $66 million, less than the total development assistance obligated in fiscal years 1983 and 1984. In Honduras, the development assistance pipeline was about $92 million as of September 1984, more than twice the annual development assistance level, but about $4 million less than the previous year. This decreased pipeline, while still substantial, indicates that AID has been able to accelerate project implementation and to overcome some of the project delays which have plagued the Honduras program in prior years.

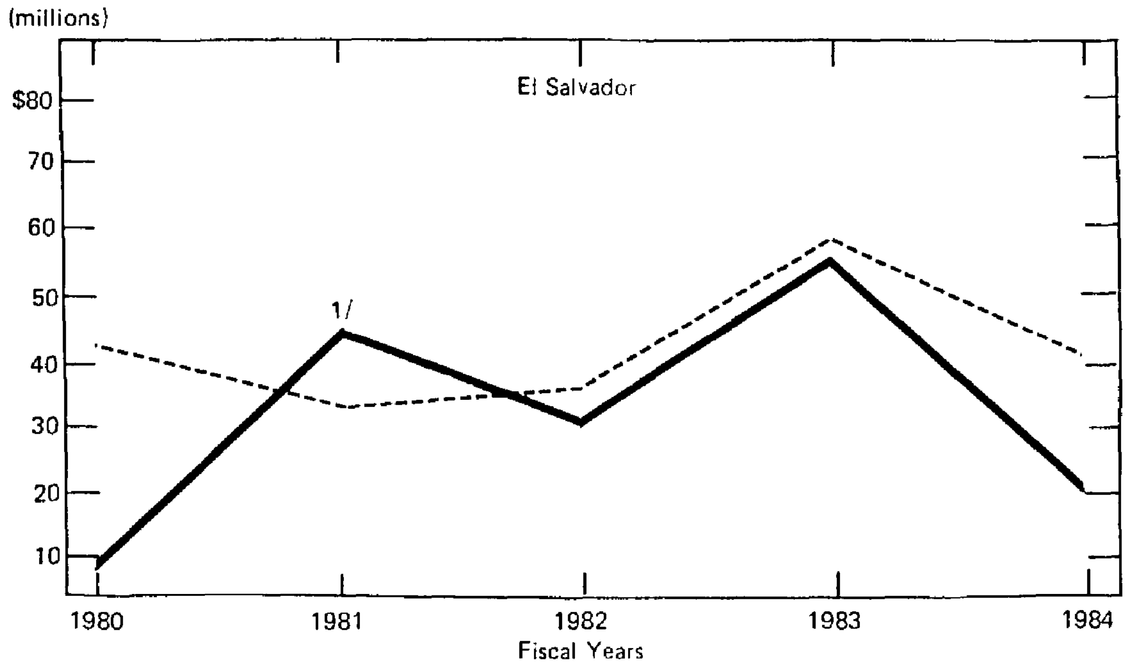
The rate of disbursement of AID project assistance is one measure of host-country and AID mission ability to absorb economic assistance. Quick disbursement, however, does not assure that the assistance will be effective. The forms of assistance being provided to El Salvador and Honduras, how AID has increased the rate of disbursements, and factors which impair program effectiveness are discussed in more detail in the following sections.

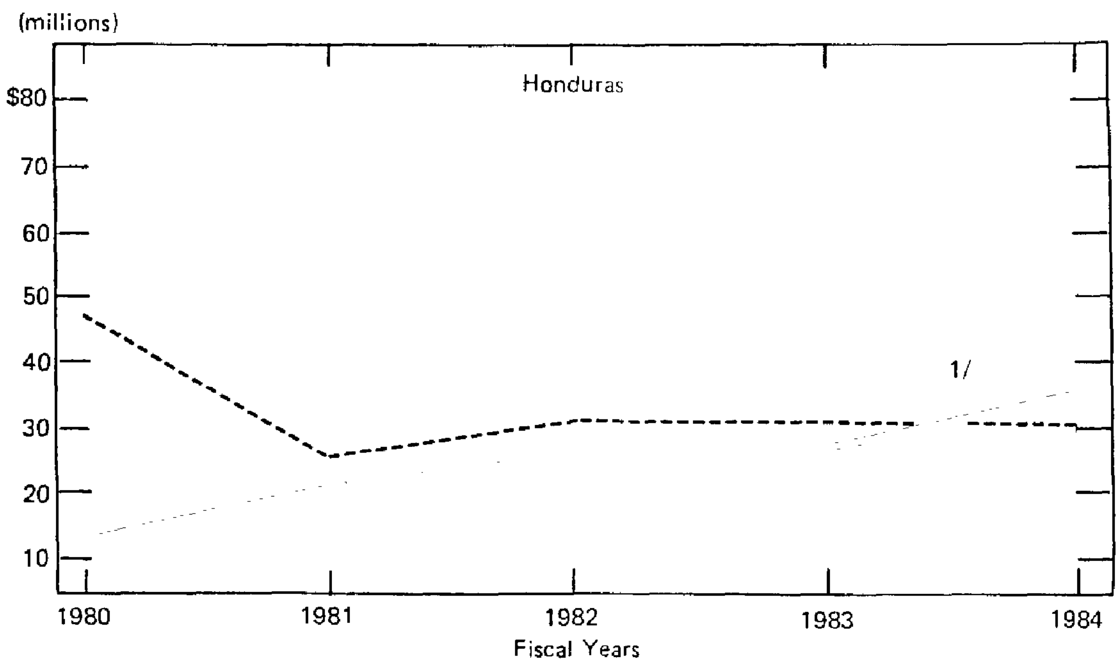
Cash transfers

The easiest way of administering economic assistance provided to a recipient country is through cash transfers--the direct transfer of dollars to a recipient country bank account. From 1982 to 1984, AID provided over $440 million in cash transfers to El Salvador and Honduras. These dollars were made available to finance AID-approved imports of goods and services. By helping to finance these imports, AID's cash transfers provide direct balance-of-payments support, thereby enhancing recipient country ability to finance imported goods and services for various purposes from their own resources. The fungibility of cash transfer assistance to Central America was discussed in a 1984 GAO report.[1]

[1] U.S. Economic Assistance to Central America (GAO/NSIAD-84-71) Mar. 8, 1984.

Development Project Expenditure and Obligation Levels





1/Expenditures are made from current and prior year obligations. When expenditures exceed obligations, AID is reducing the assistance pipeline.

------ obligations

▬▬▬ expenditures

According to AID officials, the demand for dollars to purchase imports far exceeds the available supply in both countries. AID contends that additional balance-of-payments support can be absorbed; industry in both countries is operating at partial capacity in part because of a shortage of imported raw materials and spare parts, which has constrained production and employment.

Although there is demand for additional foreign exchange, currently authorized levels of balance-of-payments support for El Salvador may already exceed the demand for imports of eligible U.S. products. AID has required that the governments of both countries attribute the cash transfer assistance to imports of specific categories of U.S. goods needed by the private sector to sustain industrial and agricultural production, even though there is no direct linkage between the assistance and the imports. Planned cash transfers to El Salvador for 1984 and 1985 of about $325 million may exceed expected requirements of currently eligible U.S. imports by $30 million to $50 million, according to AID. This does not mean that the capacity to absorb cash transfers is limited but that the capacity to absorb the specific categories of imports is limited. To associate assistance with specific imports, AID has considered broadening categories of eligible imports to include public sector imports, medicines, and other imports for which there is a demand and imports from selected countries in addition to the United States. In commenting on our draft report, AID reported that as of December 1984 it had made selected imports from Central American countries (except Nicaragua) eligible for attribution against U.S. cash transfers to El Salvador.

Foreign exchange management

Control and allocation of ESF dollars provided through AID's cash transfers are the responsibility of the governments of El Salvador and Honduras and have been a problem for each government. We reported in 1984 that the El Salvador Central Bank's allocation of foreign exchange to finance imports had been somewhat arbitrary and had not always favored the most essential imports. In addition, controls were not adequate to prevent the price of imports being overstated on invoices, thereby permitting importers to illegally send dollars outside the country--a form of capital flight.[2] AID has since worked with El Salvador's Central Bank to improve foreign exchange control procedures.

We visited the Central Bank in El Salvador to observe its foreign exchange and control systems. Although we did not sample import transactions, we observed that to improve its procedures, the Bank had

[2]A term used to refer to capital outflows for reasons of safety in politically or economically unstable countries.

--relocated the price-checking unit to increase its independence and added staff to increase its capability;

--published a list of priority imports allocated foreign exchange and the names of importers receiving foreign exchange; and

--requested AID assistance to mechanize its price-checking procedures; in response to this request, AID financed a technical assistance effort, beginning in October 1984, with the Bank's price-checking unit.

In late 1984, an AID-financed study, made to determine if these procedural changes were effective, concluded that the Bank had improved its control and allocation procedures substantially since 1983.

The Honduras government, to increase controls over foreign exchange transactions, has established a unit staffed by three persons to check prices on imports. Officials of the Central Bank of Honduras told us they plan to expand the size and coverage of the price-checking unit as a means of better controlling some forms of capital flight, which is estimated at up to $25 million a year.

AID has been generally satisfied with both governments' efforts to improve foreign exchange control and allocation procedures. However, AID believes that the need for these procedures as well as the incentive for importers to attempt to convert local currencies into dollars for capital flight can be significantly reduced through more realistic valuations of the countries' currencies, which will tend to allocate existing foreign exchange according to market forces rather than administrative procedures. (See ch. 3.) Treasury comments on our draft report shared this view.

Local currency management

When cash transfer dollars are sold to importers, local currencies are then available to the recipient government to finance activities agreed with AID. In El Salvador, for example, AID's fiscal year 1983 cash transfer assistance of $120 million provided the government with about 300 million colones (2.5 colones is equivalent to $1 at the official exchange rate), or roughly 16 percent of its entire budget. This amount was to be used for specific items within the budget, such as salaries of civil servants and operating expenses within selected ministries and contributions to AID development projects. By financing recipient country budget expenditures, AID enhances the ability of recipient countries to fund other activities with their own resources.

By jointly programming local currency priorities, AID has influenced recipient government budget expenditures. Our review of AID mission documents, however, showed that the government of El Salvador had not consistently spent all local currencies as agreed. The variance between spending targets and actual expenditures on most activities was not considered by AID to be significant. In commenting on our draft report, AID reported that expenditure shortfalls occurred because El Salvador was unable to implement some projects due to security and technical problems and because there was limited time between when AID and El Salvador agreed how local currency would be spent and the end of the fiscal year. On three controversial government activities--human rights commission, amnesty commission, and election council--AID officials told us in August 1984 that local currency expenditures were significantly less than agreed because of competing budget priorities. In its comments, AID reported that the El Salvadoran government strongly believed these activities were overbudgeted, given time available for implementation.

ESF-Generated Local Currencies
Spent on Reform Activities
(in $1,000 equivalent)

	Planned	Actual	Actual as a percent of planned
Election Council	$2,080	$1,703	82
Amnesty Commission	683	146	21
Human Rights Commission	492	281	57

The government of El Salvador also agreed in 1983 to allocate the equivalent of $13.6 million from its own resources to compensate persons whose land was expropriated under its land reform program. At the close of the year, the government notified AID that it did not have sufficient funds for this purpose, but, according to AID, it did meet its 1983 commitment in March 1984.

At AID's urging, in 1984 the government of El Salvador established a special account for ESF-generated local currencies which permits AID to more closely monitor local currency expenditures to ensure they are used only for agreed purposes. Honduras has had such a special account since cash transfers were first provided in September 1982.

Food assistance

Food assistance to El Salvador and Honduras will total about $135 million in fiscal years 1984 and 1985, approximately $123 million of it in concessional sales under Public Law 480 Title I. The concessional sale of food provides additional balance-of-payments support through long-term financing of food imports, thereby freeing up dollars which otherwise might have been used to purchase the food commercially. These food sales, compared with project assistance, can be administered relatively easily and quickly. The United States exports food to the recipient country, where it is sold on the free market. According to AID, proceeds from sales have been placed in special accounts and are used for purposes agreed to by AID and the recipient governments.

Unlike the Title I food sales program, Public Law 480 Title II food donations are distributed to the poor, whose situation has been worsened by the unstable economic and political environment in El Salvador and Honduras. Food donations to El Salvador and Honduras in fiscal years 1984 and 1985 will total about $12 million, about 1 percent of U.S. economic assistance to the two countries. Private and government organizations distribute the food directly to target populations, with AID overseeing the distribution. AID officials have reported that the Title II program was difficult to implement because target populations often live in remote locations or areas of conflict and because food is perishable and pilferable. A small amount (about 630 pounds) of food donated to El Salvador in fiscal year 1983 had been illegally sold, and AID had planned to discontinue funding for food donations administered by one private organization in Honduras because of its weak distribution and accounting procedures. We did not attempt to determine if controls and distribution procedures were sufficient to prevent food diversion. AID officials contend, however, that press allegations of misuse and diversion of food donations in El Salvador have exaggerated actual problems. They pointed out that the presence of Public Law 480 food bags in local markets does not necessarily indicate diversion of assistance, since containers are often reused to package local products as well as other uses, such as makeshift shelters. AID and embassy officials acknowledged that it is not always possible to totally prevent food diversion in AID programs. But in commenting on our draft report, AID stated that diversion of food donations categorically had not been a serious problem in El Salvador.

AID has taken action to improve its oversight of food donations. In Honduras, AID has performed spot checks of private businesses alleged to be recipients of diverted food donations. In El Salvador, it has assigned a U.S. officer and contracted for seven food supervisors to monitor food distribution and performed audits to determine if food donations are reaching the target population without undue spoilage or loss. AID's comments on our draft report describe in more detail actions taken to monitor food donation programs. (See pp. 57 and 58.)

Project assistance

In El Salvador and Honduras, AID has employed methods to avoid problems common to project assistance. Traditionally, AID projects often include long-term, institution-strengthening efforts because a primary objective of development assistance is to improve developing country ability to provide basic services and implement its own programs. Such projects often have relatively slow disbursement rates requiring long implementation periods, some for 4 to 6 years. This type of assistance is difficult to implement and requires intense AID staff involvement for design and implementation and substantial host government involvement. AID projects in El Salvador do not emphasize institution-strengthening and training. In Honduras, institution-strengthening continues to be an important part of the program, but AID is limiting assistance for institution-strengthening to what it believes the government institutions can absorb. According to AID officials, AID and the recipient governments can absorb planned assistance levels if the current project strategy is maintained; this strategy is generally not management intensive for AID, does not overtax weak recipient government institutions, and permits quick disbursement.

AID's program in El Salvador addresses the country's immediate need to repair damage to its physical infrastructure and to restore funding for social services which have been curtailed by the war. Projects in the areas of health, education, and infrastructure restoration emphasize procurement, construction, and employment generation. According to AID, such projects absorb large amounts of funds, require less staff-intensive AID management, place less implementation responsibility on the government institutions, and can be completed in shorter periods of time than institution-strengthening activities. AID officials hope to pursue more institutional development when the crisis subsides and emergency and restoration needs have been met.

Below are examples of projects in El Salvador which reflect AID's emphasis on quick disbursement.

--**Rural Primary School Expansion.** Approximately $4.2 million, or 96 percent, of project funds financed the construction of 395 rural classrooms. The project's original strategy was to use the Ministry of Education's construction unit, but an AID evaluation concluded that private firms could build the classrooms faster. Private sector builders, engineers, and architects contracted with AID funds completed construction of all classrooms in about one year. About $183,000, or 4 percent, of project funds financed institutional-strengthening activities to improve the Ministry of Education's planning capacity.

--**Health Systems Vitalization.** This 2-year, $25-million project began in late 1983 to purchase large quantities of critically needed health care commodities. About 92 percent of AID funds is primarily for imports, such as pharmaceuticals, medical supplies and equipment, warehousing supplies, and medical vehicles. As of July 1984, AID had begun procurement of over $12 million worth of these imports. Approximately $2 million, or 8 percent, of project funds will finance institution-strengthening, in this case technical assistance to improve the government's ability to manage and distribute the commodities procured.

In the early 1980's, project assistance in Honduras, unlike that in El Salvador, placed emphasis on complex institution-building efforts, such as a $15-million health sector project to improve planning capabilities and assist Honduran administration of rural health services. These projects, however, often imposed burdens on weak government institutions and have been difficult to implement, resulting in delayed project implementation schedules and large pipelines. During the past 2 years, in an effort to decrease these pipelines, AID has

--relied less on weak government institutions for implementation and more on local private sector entities and U.S. contractors;

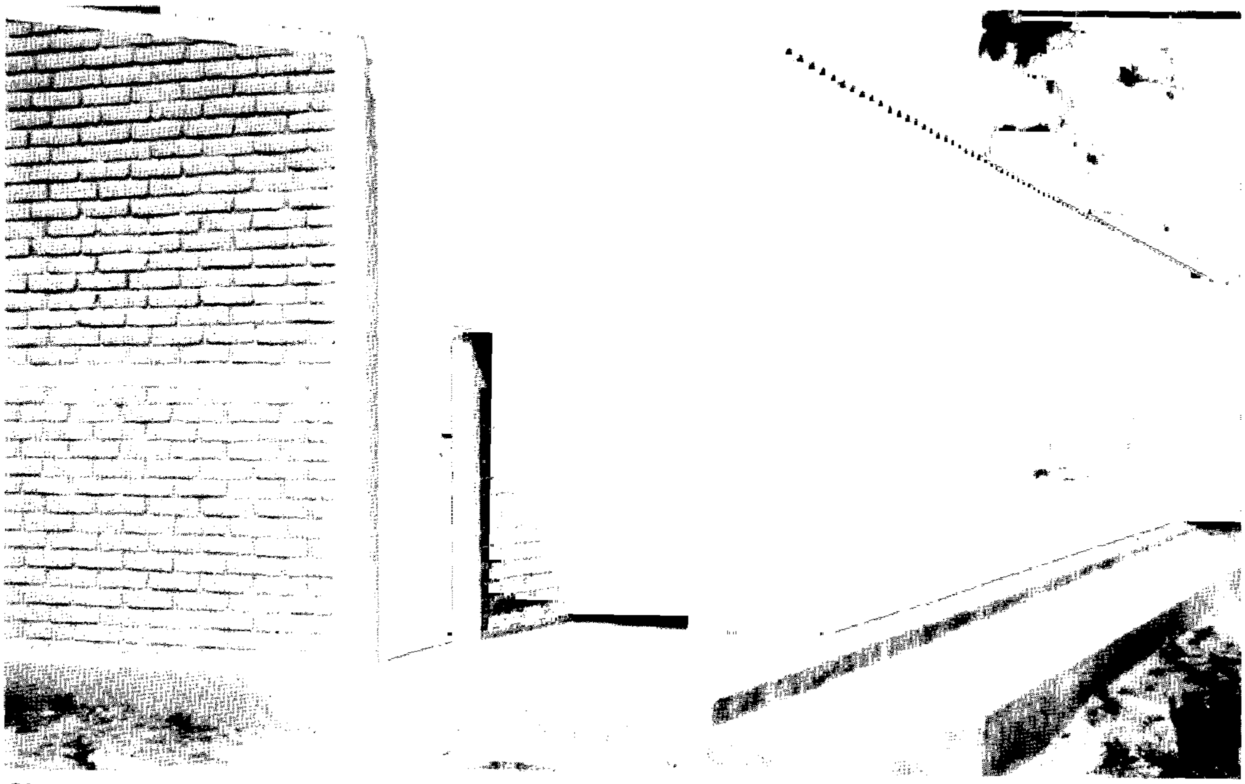
--focused more on project implementation;

--funded additions to existing projects where Honduran capabilities are already established;

--undertaken less complex projects; and

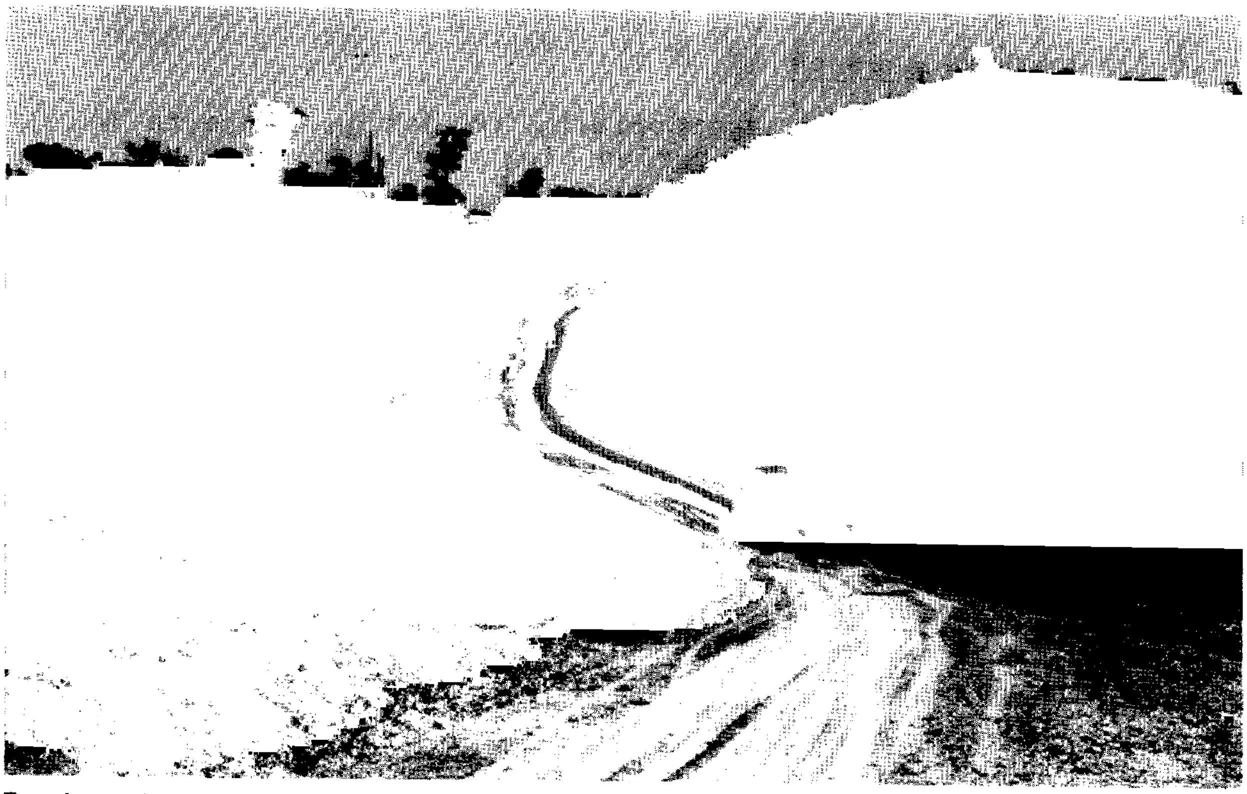
--devoted more assistance to fast disbursing construction and other projects.

This strategy enabled the mission to reduce its development assistance pipeline by about $4 million from the previous year.



Classrooms constructed with AID funds in El Salvador.

(GAO photo)



Rural road being constructed with AID funds in Honduras.

(AID photo)

Although the mission will continue its efforts to improve Honduran government institutions through training and technical assistance, mission officials told us that the amount of such assistance the government can absorb is limited. Therefore, its current strategy includes increased emphasis on projects which build infrastructure and provide employment. These projects reflect AID's efforts to emphasize quick disbursement, similar to its strategy in El Salvador. In this way, AID hopes to avoid project delays.

Mission officials in Honduras believe that projects emphasizing construction and employment will help them to maintain an acceptable pipeline in view of the limited capacity of the Honduran government to quickly absorb large amounts of assistance aimed at institutional development. For example, AID has proposed spending $25 million, beginning in 1986, on rural electrification and $15 million on road building.

CONSTRAINTS TO MORE EFFECTIVE DEVELOPMENT ASSISTANCE

Constraints to effective project implementation in El Salvador and Honduras include weak host-government institutions and inadequate host-government financial resources, constraints which are common to AID programs worldwide. In addition, AID staff levels in El Salvador at the time of our fieldwork appeared to be insufficient, given the size of the program.

Institutional weaknesses

AID attempts, when appropriate, to design projects which minimize the administrative burden placed on host-country institutions. Nevertheless, weak government institutions in El Salvador and Honduras have contributed to implementation difficulties.

According to AID, Honduras has been plagued by poorly organized and managed institutions and a lack of trained manpower which limit the capacity of the country to absorb technical assistance. Our observations and discussions during fieldwork in Honduras confirm that weak government institutions have affected project assistance. For example:

--The government's centralized procurement process averages over 100 steps requiring about 7 months to complete. According to AID reports, procurement has taken as long as 2 years in some cases (two buses needed for an AID agriculture project were received more than 26 months after the procurement process began). AID is financing technical assistance to improve the system's efficiency and has assigned contract staff to work with the government to expedite procurement on several AID projects.

--The Ministry of Health has had difficulty efficiently providing medicines, equipment, and personnel to health care centers which needed them. An AID project is upgrading the Ministry's distribution and control systems but has been adversely affected by organizational conflicts within the Ministry which are affecting financial controls, supervision, and training. As of June 1984, 88 percent of project time had elapsed but only 50 percent of project funds had been spent.

--Frequent turnover of government personnel has diminished the impact of AID's technical assistance in the past. After elections in 1981, government personnel, some of whom had received training under an AID project, were replaced.

In El Salvador, project assistance attempts to minimize reliance on recipient government institutions for implementation. However, when government institutions have been used to implement complex projects, AID has encountered implementation difficulties. For example, prior to 1980, El Salvador's National Agriculture Development Bank was a small institution providing small loans to individual farmers. In 1980, when AID began to provide large amounts of assistance in support of agrarian reform, the Bank began to provide credit to over 300 large cooperative farms while still operating with what the government and AID described as an antiquated computer system and inadequately trained personnel. Because of the institutional weakness, the Bank was slow to provide credit and services to customers during the 1983 crop year. More credit agents have been hired and a computer procurement is planned to avoid similar problems in the future.

Because of the political turmoil in El Salvador, there has been considerable turnover of key government personnel. For example, a key agency responsible for implementing the land reform program underwent a "house cleaning" after the presidential election in the spring of 1984. At the time of our fieldwork, AID officials were developing working relationships with the new leadership. The turnover interrupted discussions on reorienting the agency's objectives. In the education sector, AID modified a project in 1982, shifting its focus away from institution building because of the assassination of the Minister of Education and the ensuing organizational turmoil.

Improving the general capability of government institutions in Honduras and El Salvador could take many years. AID can continue to minimize project implementation responsibilities placed on the governments, thereby enabling AID to implement its expanded assistance programs while minimizing delay. Although it may be impractical at this time, the countries' long-term development prospects would be enhanced if AID could focus more on strengthening institutions so that El Salvador and Honduras can improve their capacity to manage future development activities.

Insufficient financial resources

AID normally requires recipient countries to finance 25 percent of the cost of AID projects. Recipient government funding--known as the counterpart contribution--is designed to assure recipient country commitment to a project. This host-government contribution is intended to also indicate a recipient country's ability to finance continuation of project activities when AID participation is completed. El Salvador and Honduras lack sufficient funds to contribute to the cost of AID projects or to maintain investments made after project completion. For example, according to an AID estimate, Honduras needed to contribute about $5.7 million to AID agriculture projects in 1984 but, due to other priorities such as government salaries and contributions to other donor projects, was able to budget less than $1 million. In order to implement these projects, AID permitted the government to use local currency generated by the cash transfer program to pay for its counterpart contribution.

AID officials in both countries told us that most, if not all, projects could continue only if the governments were permitted to use local currency generations as their counterpart contributions; however, this does not assure that funds will be available for recurrent costs. In fact, senior ministry officials of El Salvador and Honduras told us that their budgets cannot support recurrent costs for maintenance of new or existing infrastructure. Examples of budget difficulties and inability to fund maintenance and other recurrent costs are as follows.

--The El Salvador Ministry of Education allocates as much as 95 percent of its budget to salaries and administrative costs, with little available for maintenance.

--AID is financing spare parts for medical equipment in El Salvador which had fallen into disrepair because the government could not fund upkeep of the equipment.

--A recent AID evaluation of a health project in Honduras concluded that the government budget may not be able to expand sufficiently during the next several years to cover recurrent costs.

--AID concluded that the Honduras central government would not be able to fund the maintenance component of education projects as originally planned. As a result, project scope was reduced and the maintenance component was revised to shift the maintenance financing burden to local communities.

AID recognizes that recurrent cost problems threaten the sustainability of projects and that El Salvador and Honduras budgets to continue AID projects will have to increase in the future. AID officials hope to lessen recurrent cost problems by encouraging each government to adopt cost recovery techniques, such as charging users for some health services. However, until Honduras and especially El Salvador can focus more resources on development activities rather than military needs and until macroeconomic conditions improve in each country, long-term, recurrent-cost problems will continue to threaten project maintenance and sustainability. AID officials hope that their efforts to influence macroeconomic reforms to promote economic growth will, in the long run, provide these governments with more revenue, thereby making it possible for them to finance recurrent costs. (See ch. 3.)

Staff constraints

In April 1984, AID reviewed its staff resources in Central America to determine if they were adequate to implement the increased assistance. The Workforce Assessment Team Report, issued in June 1984, recommended that U.S., foreign national, and contract staff be increased in both El Salvador and Honduras. Notably, the report recommended that the level of U.S. direct-hire employees be increased as shown on page 22. Because AID's worldwide staff ceiling has been limited by the Office of Management and Budget, adding staff to the missions in El Salvador and Honduras, as recommended, may require reassignment of staff from other missions or headquarters.

U.S. Direct-Hire Positions

	Approved	Recommended positions
El Salvador	32	39
Honduras	32	35
Total	64	74

El Salvador mission officials' views expressed during our fieldwork were consistent with the report's conclusion that staffing shortages existed. They believed the mission had been able to avoid widespread management problems by working overtime, but they feared the demands on staff could not be sustained indefinitely. They told us that staff shortages were affecting the implementation of some programs and that without additional staff, it would be difficult to increase technical assistance and institution-building activities.

Project officers told us that the overall workload, not security concerns, was the primary factor limiting their ability to monitor projects. Although we observed that the embassy security officer in El Salvador often advised AID staff not to visit project sites for a period of days because of reported guerrilla activity, project officers termed this an inconvenience and stated that eventually they are able to make their trips, although sometimes at personal risk. AID mission officials contended that the workload had made it difficult for project officers to make the number of site visits they believed prudent.

Because of lack of staff, the AID section responsible for the highly complex and controversial agrarian reform projects contended it had not always been able to adequately monitor project activities. AID assigned Salvadorans to fill key roles in working with government institutions receiving large amounts of U.S. financial and technical assistance to implement land reform. Although it is normal AID practice to use local personnel in mission staffing, AID officials believed that use of Salvadoran nationals in such key project roles was less desirable, given the sensitivity and complexity of AID's agrarian reform projects. Moreover, AID officials told us that U.S. personnel could better serve in these roles because they are more familiar with AID policies and procedures and can establish closer bilateral working relationships and more effectively oversee technical assistance contracts. By reassigning staff responsibilities in the summer of 1984, AID assigned an additional U.S. employee to help manage the land reform projects but, in doing so, eliminated a U.S. position needed for efficient administrative support for all AID's agricultural projects.

AID mission officials listed the following examples of actual or potential management problems caused by staff shortages.

- --Lack of technical procurement specialists delayed purchase of a computer system needed by El Salvador's Agricultural Bank to process and control AID assistance provided as credit to landowners and cooperatives. AID officials acknowledged that, in hindsight, the Bank needed a computer system several years ago, but AID could not identify the problem until recently because of a lack of staff resources, expertise, and time to closely examine the Bank's ability to efficiently process and control loans and repayments.

- --Existing staff levels prevented AID from initiating projects to strengthen El Salvador's institutions. A project to strengthen the Education Ministry might not be implemented in 1985 unless additional staff are added.

- --The Controller's Office had only three U.S. direct-hire staff to handle financial review and control responsibilities, even though some AID missions with the same number of U.S. direct-hire controller staff manage programs much smaller in size. Due to the increasing size and complexity of the AID program, the Controller had not always been able to provide the desired degree of review, thereby risking error.

Staffing shortages are compounded because AID's El Salvador program receives unusually high attention from the media, the U.S. Congress, and interested groups in the development community. AID officials believe this attention is healthy but noted that AID staff must spend considerable time responding to inquiries in addition to their project management activities. For example, the officer in charge of mission health and education activities told us he spends several hours each day responding to program inquiries. Mission staff responsible for land reform projects also contend that frequent inquiries and visits divert their time and attention away from normal project activities.

Although there was general agreement that the mission needed more staff, corrective action has been impeded by two factors. First, for physical security reasons, the ambassador had discouraged adding new AID positions unless existing secured workplace can accommodate them. Additional secured office space is under construction but is not expected to be ready for use until August 1985. According to AID's Workforce Assessment Team Report, available working space was "overcrowded" and "extremely unsatisfactory." We observed the overcrowded work environment during our fieldwork.

Second, AID has had difficulty recruiting U.S. staff to serve in El Salvador; advertised vacancies have resulted in few qualified applicants. We were told by mission staff that security conditions and excessive workloads may explain why few applicants have applied for vacancies. AID officials told us that the position of head of the mission's agrarian reform activities went vacant for 18 months; during our fieldwork only 29 of the mission's 32 positions were filled. AID's Workforce Assessment Report recommended that, if recruitment problems continue, AID consider appointing qualified officers to fill selected vacancies in El Salvador on a non-voluntary basis rather than rely on volunteers as a solution to this problem.

In Honduras, the Workforce Assessment Team Report recommended staff increases to buttress mission capability to monitor agricultural, humanitarian, and private sector projects. The report also suggested additional staff for procurement, economic analysis, and financial review and control. The AID mission plans to augment existing staff during 1985.

CONCLUSIONS

AID's assistance programs in El Salvador and Honduras are structured to permit more timely disbursement of the increased assistance levels. Balance-of-payments assistance provided by cash transfers and food sales, which is the major component of AID's programs, can apparently be absorbed. As discussed in the next chapter, its ultimate effectiveness in economic terms will depend heavily on the ability of AID to influence the enactment of appropriate macroeconomic policies. AID's project assistance has been designed to minimize the delays which host-country institutional weaknesses and financial resource constraints can cause. Sustainability of these projects will depend largely on AID's ability to influence policy reforms to promote economic growth, thereby increasing the countries' resources available for recurring project costs, and the extent to which host-country institutions can be strengthened so they can better manage AID project activities in the future.

AID could improve on the overall administration of its El Salvador program by providing sufficient staff to the mission. However, until additional secured workplace is available and AID entices more volunteers or decides to assign staff on a non-voluntary basis, mission efforts to manage its expanding program will be hindered.

AGENCY COMMENTS AND OUR EVALUATION

AID commented that our draft report discussion of Honduran government institutional capacity and of AID plans to work more with private sector entities suggested that AID was abandoning its traditional development activities. AID believes there is adequate institutional capacity in selected government agencies and therefore plans to continue to rely on Honduran government agencies with demonstrated capacity. Nevertheless, AID acknowledged government of Honduras limitations. We revised our report accordingly.

Regarding staffing levels in El Salvador, AID acknowledged that staffing was a key problem at the time of our fieldwork. Since then, AID said it has added four of the seven additional U.S. staff recommended by the Workforce Assessment Team and that the remaining three staff are scheduled to arrive by August 1985, when construction of a new secured workplace is completed. In addition, AID has taken other actions to increase workforce capability, which are detailed in its comments in appendix I. These actions, AID believes, will correct the actual and potential management problems referred to in our report.

Regarding food donations, AID believed the draft report suggested a serious problem in the monitoring and control of food donations, which AID denies. This was not our intention. We stated that we did not evaluate the adequacy of AID's controls and distribution procedures. Therefore, we cannot conclude that they are or are not adequate. However, we did note that AID has taken a number of actions to improve monitoring of the relatively small food donation programs.

The Department of the Treasury commented that the chapter concentrated too heavily on technical administration of assistance funds and not enough on the broad economic problems causing balance-of-payments gaps. Further, Treasury believes that AID's emphasis on quick disbursement of assistance means that the impact of aid may be limited to filling existing gaps rather than improving prospects for self-sustaining economic growth and appropriate public sector activity.

The purpose of this chapter was to identify and discuss factors associated with program administration. We agree, however, that fundamental economic problems which AID's balance-of-payments assistance, the major program component, seek to correct are fundamental issues. Chapter 3 is devoted to a discussion of these economic problems and efforts to promote policy changes to overcome them.

CHAPTER 3

AID INFLUENCE OVER MACROECONOMIC POLICY

The effectiveness, in development terms, of economic assistance to El Salvador and Honduras depends heavily on fundamental macroeconomic reforms. AID has sought to influence recipient-government policy actions to promote long-term economic stabilization and growth while providing balance-of-payments support to stabilize their economies in the short term. AID has influenced some policy changes, but key policy measures specified in AID's Congressional Presentations and other program documents which AID believes are necessary to meet U.S. development objectives have not always been taken. The governments of El Salvador and Honduras have been reluctant to implement policy measures to correct fiscal and foreign exchange imbalances, because such action would be politically difficult. Due to U.S. security and political objectives, AID and the Department of State have not always required that such measures take place before providing additional balance-of-payments assistance.

By enacting macroeconomic reforms, AID believes that Honduras and El Salvador could lessen the need for external balance-of-payments assistance. We believe it would be advantageous for the United States to reach more interagency agreement on the degree to which economic assistance should be used to influence economic reforms in El Salvador and Honduras. This agreement should be consistent with overall U.S. security and political objectives and should consider economic costs. Estimating the costs of future U.S. assistance in the absence of economic reforms could permit a more fully informed discussion of the trade-offs involved in not conditioning U.S. assistance on reforms.

ECONOMIC REFORM IS CRUCIAL TO AID'S PROGRAM

In January 1984, the National Bipartisan Commission on Central America recommended a 5-year, $8-billion assistance program to promote regional security through economic stabilization and growth. The Commission noted that many severe economic problems faced by Central American countries have been perpetuated, in part, by inappropriate macroeconomic policies. The Commission concluded that effectiveness of economic assistance to Central America, regardless of the amount, depends on significant economic reforms.

AID and State justifications of economic assistance funding requests have echoed the Commission's findings and proposed that assistance be conditioned on demonstrations by Central American governments of their commitment and ability to undertake fundamental economic reforms. For example, the Department of State, in describing its plan for increased assistance to Central

America in February 1984, proposed "to provide large-scale balance-of-payments assistance, conditioned on steps by governments to increase exports and conserve on imports for consumption to restore external balance" and to "achieve economic stabilization by eliminating unfinanced balance-of-payments" gaps as a matter of immediate priority. AID's macroeconomic assistance strategy was to encourage El Salvador and Honduras to adopt economic stabilization programs which should include exchange rate adjustments.

Economic crises

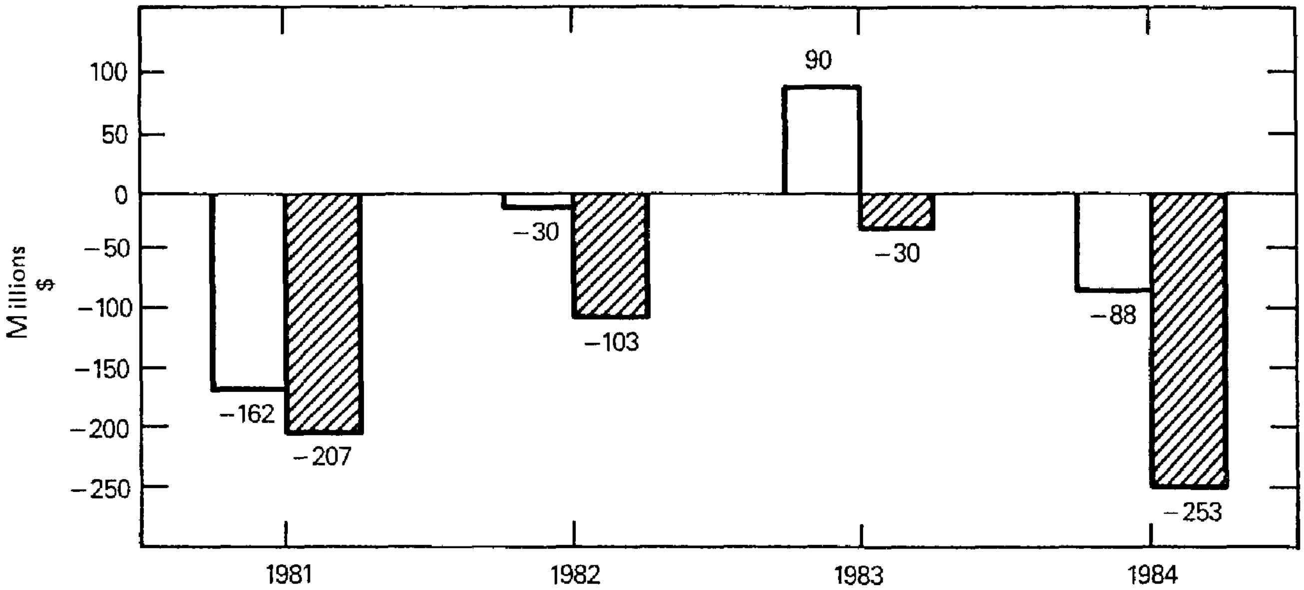
The economies of El Salvador and Honduras have deteriorated badly. World recession, price increases in oil imports, and price decreases in traditional agricultural exports have damaged their economies. Equally damaging have been the regional political instability and civil strife which have discouraged investors, limited supplier credits, drained resources available to improve living conditions, and dampened prospects for economic expansion.

Economic data from AID and the Department of State illustrates the magnitude of the problems in both countries. Between 1978 and 1983, El Salvador's economic production dropped by 25 percent. In the same period, population grew by 2.8 percent each year. As a result, the real standard of living in El Salvador has fallen by one-third. According to AID data, estimated per capita income is $700--more than Honduras but less than other Central American countries receiving AID assistance. AID estimates economic growth of 1.5 percent in 1984, less than the 3 percent needed to keep pace with population growth. Exports dropped about 40 percent between 1978 and 1983, and payments on external debt grew to one-third of all export earnings, creating a balance-of-payments deficit estimated at $250 million in 1984 had not ESF assistance been provided. Military spending has limited the availability of resources for programs to maintain living standards, promote social services, and deal with humanitarian problems. The State Department estimated that the war in El Salvador has caused as much as $800 million in direct damage to infrastructure and production in addition to increasing military costs. In August 1984, the government of El Salvador projected a 1984 fiscal deficit of $112 million.

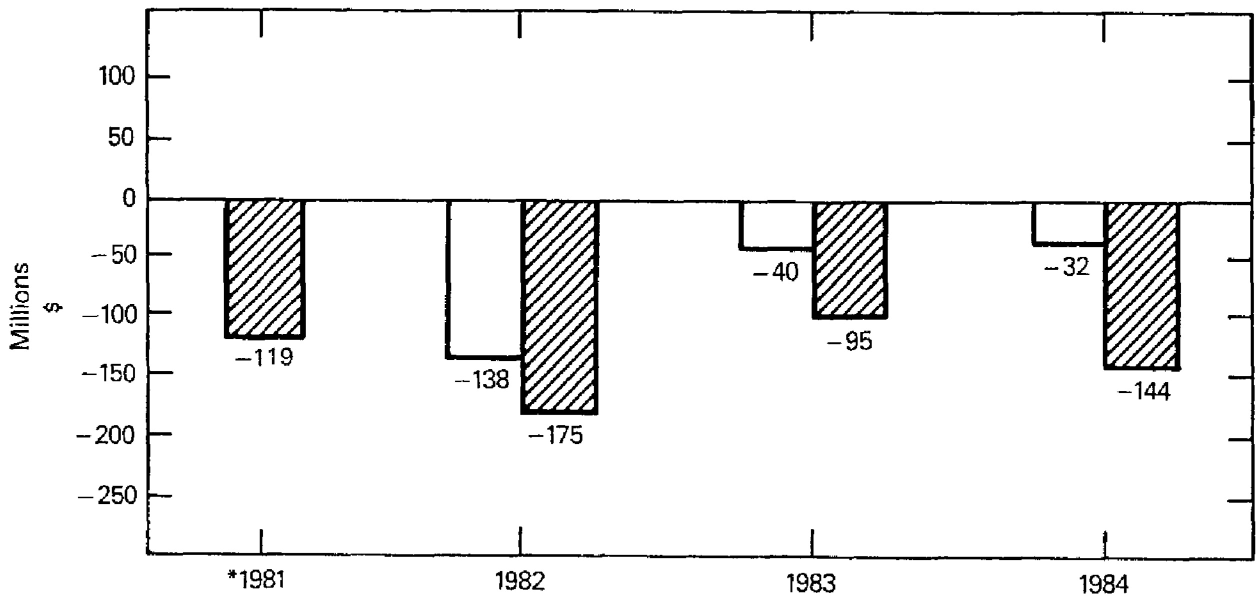
Economic conditions in Honduras are also weak. Debt obligations, defense spending, and declining tax revenues created a fiscal deficit of almost $300 million in 1983. As a result, resources have not been available to accelerate improvements in living standards, which historically have been lower than in almost all Western Hemisphere countries. Per capita income is currently estimated at only $660. In the Western Hemisphere, only Haiti and Bolivia have lower estimated per capita incomes, $300 and $600, respectively. As of November 1984, the State

Balance-of-Payments Deficits

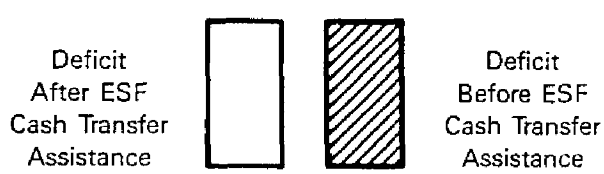
El Salvador



Honduras



*No ESF assistance was provided to Honduras in 1981



Department estimated 1984 economic growth of 2 percent in Honduras and a 1984 balance-of-payments deficit exceeding $140 million without ESF assistance.

Overall economic performance would be worse if it were not for the large amount of U.S. balance-of-payments assistance. This assistance has enabled both countries to purchase imports, without which their economies would have deteriorated further. But even with this support, serious balance-of-payments deficits remain. The graphs on page 28 illustrate balance-of-payments deficits before and after cash transfer assistance, assuming no other adjustments.

Policy change needed for economic stability

The National Bipartisan Commission on Central America reported that economic policies pursued by Central American countries have contributed in part to their current crises. The Commission report placed priority on achieving economic stability--a necessary prerequisite for economic growth and political stability. Consistent with the Commission report, AID's programs in El Salvador and Honduras have encouraged actions to reduce central government deficits, make tax systems more fair and equitable, and improve incentives for private business in order to stabilize the economies. AID and embassy officials in both countries told us, however, that these measures alone cannot achieve economic stability without changes to existing exchange rate policies--changes that both El Salvador and Honduras have resisted largely for political reasons. (See pp. 36 and 37.)

The current exchange rate in each country substantially overvalues the host-country currency. This stimulates imports by setting artificially low prices and lowers demand for exports by setting artificially high prices. The worsened balance-of-payments deficits have been financed in part by high levels of ESF assistance provided to both countries.

The Honduran currency, the lempira, is officially valued at 2 per $1.00. However, each dollar purchased on the black market as of September 1984 cost about 2.6 lempiras. El Salvador's currency, the colon, is officially valued at 2.5 per $1.00, but in August 1984 could be purchased on the black market at a rate of slightly more than 4 per $1.00. El Salvador has established a second legal exchange rate, referred to as the parallel exchange rate,[1] of 3.95 colones per $1.00 for a portion of its imports and exports, which more closely reflects

[1]A separate rate which applies to designated transactions. Compared to the official exchange rate, the parallel rate more closely represents the market rate. Use of a parallel rate, in effect, is a partial devaluation.

the market value of its currency. Honduras has not legalized a parallel market. According to AID economists, the Honduran and Salvadoran currencies were overvalued by about 30 to 40 percent at the time of our fieldwork.

AID believes that exchange rate adjustment is a measure which in conjunction with fiscal and monetary actions is key to fostering export competitiveness. AID argues that host-country policy actions to foster export competitiveness would increase domestic employment and investment and would complement AID efforts to promote private sector growth and assist El Salvador and Honduras to increase exports to the United States, as contemplated by Caribbean Basin Initiative provisions which grant tariff relief for most categories of exports to the United States. In addition, we were told that exchange rate adjustments would also encourage local production of items which are currently imported.

Unless actions are taken to lessen the balance-of-payments deficits, AID believes the economic situation in both countries will remain unstable and could require increasingly large levels of external assistance. Presuming a continued U.S. interest in achieving economic stability in Honduras and El Salvador, meeting this requirement would involve future costs to the U.S. government. We asked how much assistance would be required in the absence of further economic policy adjustments, but AID officials told us they have not projected such costs and that accurate estimates are difficult to make. However, AID economists in Honduras told us that, based on their rough estimates, Honduras may require up to $250 million of balance-of-payments support in 1985 and more in future years, if it does not make economic policy adjustments.

OPPORTUNITIES TO INFLUENCE REFORMS

From 1982 to 1984, AID disbursed $320 million in ESF balance-of-payments support to El Salvador in 11 cash transfers and $121 million to Honduras in 6 cash transfers, as shown on page 31. Each of these cash transfers presented an opportunity for AID to influence implementation of economic reforms.

ESF Balance-of-Payments Support

El Salvador

Date of disbursement	ESF (millions)	Cumulative total (millions)
July 1, 1982	$25.0	$ 25.0
Sept. 28, 1982	75.0	100.0
Feb. 9, 1983	19.6	119.6
Mar. 29, 1983	20.0	139.6
May 13, 1983	25.0	164.6
May 31, 1983	17.4	182.0
Oct. 18, 1983	20.0	202.0
Dec. 2, 1983	18.0	220.0
Mar. 29, 1983	25.0	245.0
Aug. 2, 1984	50.0	295.0
Nov. 9, 1984	25.0	320.0
Honduras		
Sept. 29, 1982	$35.0	$35.0
Apr. 29, 1983	3.0	38.0
Aug. 1, 1983	15.0	53.0
Mar. 7, 1984	12.0	65.0
June 13, 1984	26.0	91.0
Aug. 21, 1984	30.0	121.0

AID can use ESF balance-of-payments assistance to influence host-country economic policies in three ways.

1. To require that policy changes occur before assistance is provided.

2. To obtain agreement that the recipient government will take actions after assistance is provided.

3. To hold policy discussions with host-country officials, even though changes to policies are not directly linked to the assistance.

Although overall foreign policy motivations are dominant in the provision of ESF assistance, AID believes that ESF balance-of-payments can still be a useful means of influencing economic policy changes, because ESF can be disbursed quickly and in amounts and timeframes commensurate with need and host-country progress in making necessary reforms. Further, since ESF assistance provides a short-term solution to balance-of-payments problems, it is appropriate, in our opinion, that it also support economic reforms leading to long-term solutions to those problems.

INFLUENCE ON POLICY CHANGE LESS THAN PLANNED

AID and the Department of State have not always taken full advantage of opportunities to influence policy change. AID Congressional Presentations, testimony, and program documents indicated that balance-of-payments assistance to El Salvador and Honduras would permit AID to influence economic reforms and that ESF balance-of-payments support would be conditioned on reform actions by recipient governments. AID missions in El Salvador and Honduras believe this assistance has been a key factor in prompting these governments' actions on some fiscal and monetary policies. However, we found partial action by the government of El Salvador and little action by the government of Honduras on those policy changes which AID believes are most necessary for economic stabilization and growth and less influence over macroeconomic policies than AID planned. Our analysis shows that AID and the Department of State have not always included reforms in assistance agreements as planned and, in several cases, have disbursed funds when required actions had not been taken.

In its fiscal year 1985 Congressional Presentation for El Salvador, AID reported it would emphasize actions which would move toward unifying the official and parallel market exchange rates to reduce the chronic imbalance between the demand and supply of foreign exchange. According to a January 1984 ESF program document, AID hoped that the government of El Salvador would accomplish complete unification of the exchange rates by the end of 1984. According to fiscal year 1984 program documents, the government of El Salvador was to allow substantial portions of coffee, shrimp, and cotton export proceeds to be exchanged at the parallel rather than official rate as a first step toward exchange rate unification. AID believed these actions were necessary to increase profitability of traditional exports, thereby helping to prevent further deterioration of El Salvador's balance-of-payments situation. Without increased profits, AID believed that producers would have little incentive to increase or even maintain production levels. It was particularly concerned about trends toward disinvestment in the coffee industry, which is El Salvador's principle export and source of foreign exchange.

According to AID, the government of El Salvador has enacted some measures to increase profitability of traditional exports and to address fiscal problems in conjunction with the ESF balance-of-payments assistance. For example, it decided to exchange a portion of shrimp and cotton export proceeds at the parallel exchange rate and required that about $75 million of imports be purchased at the parallel exchange rate rather than the official rate. At the time of our fieldwork, AID estimated that 25 to 30 percent of all import and 15 to 20 percent of all export transactions occurred at the parallel rate of 3.95 colones to $1.00. In commenting on our draft report, AID reported that the government of El Salvador had shifted additional transactions to the parallel market. As of November 1984, 42 percent of imports and 28 percent of exports were transacted at the parallel exchange rate, and as of March 1985, 42 percent of both imports and exports were transacted at the parallel rate. This represents an important exchange rate adjustment but is less than the full unification of exchange rates AID had hoped would occur. AID has not required El Salvador to enact a devaluation that would affect all imports and exports as a condition of any of its ESF disbursements.

AID had proposed other conditions to increase export and import transactions taking place at the parallel exchange rate. For example, according to assistance justification documents, AID planned to condition part of its 1984 ESF assistance on government measures to permit coffee export proceeds to be exchanged at the parallel rate. However, AID disbursed the assistance without requiring this action. AID also planned to condition a $25-million ESF disbursement in late 1984 on progress in negotiations for an arrangement with the International Monetary Fund (IMF)[2] and on exchange rate adjustments. Because the government of El Salvador indicated that some action would be taken on these issues, ESF assistance was provided without requirements for reforms prior to disbursement. According to AID and State comments on our draft report, El Salvador subsequently shifted import and export transactions to the parallel market and indicated it would undertake a more comprehensive economic program by the end of 1985.

In Honduras, AID has discussed the need for exchange rate adjustments with government officials but has not made full devaluation or establishment of a parallel market a condition of assistance. We found that ESF assistance to Honduras has influenced the government to form a high-level Honduran and U.S. policy group to discuss and develop an action plan for macroeconomic reforms and to pass an AID-endorsed economic stabilization package designed in part to reduce government deficits. In addition, central bank procedures were changed to enable issuance of import licenses to importers who already had foreign exchange, even if this exchange had been obtained illegally. AID economists hope this limited measure reflects

[2]A multilateral financial institution which provides balance-of-payments loans tied to economic reforms by recipient countries. Office of Management and Budget comments on our draft report provide additional information and views on how IMF operates. (See pp. 71 and 72.)

Honduran recognition of the need to adjust the exchange rate. AID believes that these changes, while significant, are not sufficient and that further exchange rate adjustments are needed.

AID told us that participation of the IMF has been an essential element of its strategy to stabilize the economies of El Salvador and Honduras. AID program documents proposed using ESF disbursements to encourage both countries to seek, obtain, and comply with IMF arrangements.

In El Salvador, an arrangement with the IMF expired in July 1983. Although AID and the government of El Salvador had agreed in 1983 that the assistance program was based upon progress in negotiations with the IMF for a new arrangement, attempts to have the government and the IMF begin negotiations have not been successful thus far.

In Honduras, AID's attempts from 1982 to 1984 to link ESF assistance to IMF reforms have met with little success. ESF agreements signed in March, July, and September 1983 required compliance with an active IMF arrangement. In November 1983, when the government of Honduras did not comply with IMF requirements, AID suspended disbursements. But AID resumed assistance in March 1984, waiving the requirement for compliance with IMF conditions because Honduras lacked dollars to purchase urgently needed imports and because the Honduran government, as a result of discussions with AID, was planning tax and revenue restraint measures to lessen the fiscal deficit.

AID's Congressional Presentation, presented in early 1984, reported that ESF assistance would support a new arrangement to be negotiated between the government of Honduras and the IMF. In mid-1984 the administration did express to the Honduran government the need for additional economic reform involving initiation of negotiations with the IMF. However, in view of the serious economic problems and their perceived threat to the democratic process, the administration directed an August 1984 disbursement of $30 million in ESF, again waiving AID conditions for Honduras to reach a new IMF arrangement. AID officials told us that exchange rate adjustment would facilitate resumption of serious negotiations to reach a new arrangement.

Summarized on page 35 are the major policy categories, reported in Congressional Presentations and other program documents, on which AID hoped El Salvador and Honduras would take action but did not necessarily require them to and the reported economic performance targets for AID's balance-of-payments assistance. The tables show that, at the time of our fieldwork, some progress had been made toward achieving the goals but that AID's balance-of-payments assistance had not met all of its objectives, which may indicate that the goals were overly optimistic.

Summary of Macroeconomic Reform Progress

El Salvador

Category	Progress made	Goals not achieved
Exchange Rate Policy	About 20 percent of export and 25 percent of import transactions were conducted at parallel exchange rate. [a]	Unified exchange rate not achieved.
Economic Growth	Past declines in gross domestic product were arrested in 1983, and growth of 1.5 percent expected in 1984.	AID's original growth targets not met.
Fiscal Measures	Government increased stamp tax and utility rates and limited government salaries to a 10 percent increase.	Budgets with unfinanced gaps not eliminated.
Management of Resources	Foreign exchange management improved.	ESF generated local currencies not always used as agreed.
Negotiation of an IMF Arrangement		No arrangement with the IMF negotiated.

[a]As of March 1985, AID reported that 42 percent of import and export transactions were taking place at the parallel exchange rate.

Honduras

Category	Progress made	Goals not achieved
Export Incentives and Exchange Rate Policy	U.S.-Honduras economic policy discussion group established and export incentive law enacted.	Official exchange rate not adjusted and balance-of-payments equilibrium not restored.
Fiscal Measures	Government passed economic stabilization package and implemented tax and fiscal restraint measures to reduce the deficit.	Projected central government budget deficit not sharply reduced.
Negotiation of an IMF Arrangement		Government did not comply with previous IMF arrangement nor negotiate new arrangement.

In commenting on our draft report, AID said that the summary table understated accomplishments, and it provided additional information on reforms made, including actions taken since our fieldwork. (See pp. 52 to 54.) For example, Honduras imposed a moratorium on central government guarantees of private sector debt and El Salvador abolished all vacant government positions. Although these actions are positive in nature, they do not, in our view, reflect major policy changes. Therefore, we did not include them in the summary table.

FACTORS COMPLICATING POLICY INFLUENCE

AID mission and embassy officials explained that influencing reforms is a very difficult process and cited several factors which complicate AID's policy reform efforts, such as:

--The governments of El Salvador and Honduras are reluctant to adjust their exchange rates for fear of potentially adverse political and short-term economic consequences.

--Neither country has a current IMF arrangement or resident IMF officials to advise it; according to Treasury, both countries have been reluctant to initiate substantive dialogue with the IMF.

--Conflicting U.S. political, economic, and security objectives have made it difficult for AID to present a consistent and unified U.S. position on the importance of macroeconomic reform in El Salvador and Honduras. (See pp. 39 to 41.)

Reluctance to devalue currency

The governments of El Salvador and particularly Honduras have been reluctant to adopt more realistic exchange rate policies, which AID believes are crucial to the success of host-country economic stabilization efforts. Their officials fear that devaluation, among other things, could increase the cost of living and precipitate wage demands, which could have negative political consequences.

Early in 1984, AID believed that it had convinced El Salvador to make gradual and steady progress toward exchange rate adjustment. However, the new government elected in May 1984 initially resisted exchange rate adjustments. That government, hoping to strengthen its political support in preparation for March 1985 elections, believed that any further move on the exchange rate issue, such as increasing import and export transactions taking place at the parallel exchange rate, could have negative political repercussions. Subsequent to our fieldwork, however, El Salvador made exchange rate adjustments as noted previously.

In Honduras, the government is reluctant to adjust the exchange rate for fear that it would cause inflation and unemployment. According to AID and embassy officials, Honduran government leaders are also concerned that exchange rate policy actions might imply government mismanagement of the economy and could be politically damaging in Honduran presidential elections scheduled for November 1985. AID officials told us that as these elections approach, substantial action on exchange rate adjustment would become increasingly difficult.

U.S. government officials in both countries explained that the official exchange rates have remained constant for decades. El Salvador officials told us that the official exchange rate has a significance well beyond its economic impact and that many Salvadorans view it as part of their national heritage. An embassy official in Honduras said that the official exchange rate had become almost a religion, and Honduran officials would find change very difficult despite the strong underlying economic rationale.

Limited involvement of the IMF

Neither El Salvador nor Honduras have active IMF arrangements. The absence of IMF macroeconomic programs and limited AID coordination with the IMF have made AID's economic reform objectives more difficult to achieve.

El Salvador's last arrangement with the IMF expired in July 1983. Negotiations for a new arrangement have not been held since that time, although an IMF economic consultation team visited the country in August 1984 to assess El Salvador's economy. According to government and AID mission officials, additional exchange rate adjustments and measures to correct the fiscal deficit would facilitate negotiations for a new IMF arrangement.

Honduras reached an arrangement with the IMF in late 1982. In November 1983, the IMF suspended the arrangement and stopped further disbursements, in part because the government had not undertaken agreed tax reforms and had exceeded the agreed ceiling on public sector credit. AID mission officials advised us that government agreement to adopt a more flexible exchange rate policy would facilitate serious negotiations for a new arrangement. In commenting on our draft report, AID noted that discussions on fiscal year 1984 supplemental and fiscal year 1985 ESF balance-of-payments assistance have not attempted to make the existence of an IMF arrangement a condition of assistance. Rather, AID's objective is a macroeconomic policy framework conducive to stabilization and long-term growth which, at the same time, may facilitate negotiations between the recipient governments and the IMF.

In addition to the financial resources which the IMF can provide, AID and other U.S. government agencies believe that new IMF arrangements would benefit both El Salvador and Honduras for several reasons.

1. It is difficult for AID or any bilateral donor to bear the political burden of insisting on unpopular policy actions, such as devaluation. The IMF does not operate with the same political and foreign policy considerations, so AID mission and embassy officials believe it would be politic to let the IMF require economic reforms and then condition AID assistance on compliance with IMF programs or those IMF reforms which AID also believes are necessary. In commenting on our draft report, Treasury stated that the IMF is best equipped to pursue comprehensive economic reforms which often involve politically sensitive issues. (See pp. 67 and 68.) Office of Management and Budget comments on our report provide additional information and views on the advantages of providing AID assistance within the context of IMF arrangements. (See pp. 71 and 72.)

2. An IMF arrangement gives a country an "economic seal of approval," which could free up credit from other international financial institutions as well as private organizations and lead to debt reschedulings. For example, AID officials said that the World Bank may consider providing foreign exchange loans, but only after Honduras reached an arrangement with the IMF.

3. IMF economic expertise could help analysis of the recipient country's economy and could advise AID and the host-country on macroeconomic trends and policy measures.

AID mission economists in El Salvador and Honduras also emphasized their desire for increased coordination with the IMF, even in the absence of formal arrangements. According to AID officials, there is little technical working level coordination between AID missions in these two countries and the IMF. Some AID officials contended that such coordination is complicated by

U.S. Treasury Department requirements for a formal approval process prior to U.S. government contact with IMF staff. Even when contact is made, however, we were told that country-specific problems, strategies, and recommended solutions are seldom discussed in detail. In commenting on our draft report, Treasury said that current procedures for contact with the IMF do not constrain dialogue. Treasury believes that the U.S. government has ample information on IMF programs and that attempts by the U.S. government to become more directly involved with IMF's negotiating process would threaten IMF independence, which is essential to its success.

AID mission officials would like the IMF to send representatives to El Salvador and Honduras to work with the governments to design and implement economic stabilization strategies and to encourage that policy reforms promoted by AID and IMF be mutually supportive. Such coordination is considered important by some AID officials for the most effective use of U.S. economic assistance. The AID mission in Honduras noted that the burden falls on AID officials in Washington to keep communication channels open with the IMF.

Conflicting U.S. objectives

The use of economic assistance to influence policy reform actions is complicated by the political and security objectives of U.S. assistance to El Salvador and Honduras. Macroeconomic reform is a top priority for AID but not always for other U.S. agencies.

Although AID implements the ESF program, the U.S. Department of State is responsible for policy direction of ESF assistance. According to State officials, ESF is intended first as a foreign policy tool and then as a development mechanism. They caution against rigidly requiring macroeconomic reforms at the expense of other U.S. objectives.

We found little disagreement among U.S. agencies that ESF assistance should be promoting U.S. political, security, and economic development objectives in El Salvador and Honduras, but lack of consensus as to the specific actions the United States should take to meet these objectives. The State Department, as lead agency on ESF policy direction, is an integral part of negotiations on economic reforms as well as on ESF disbursement decisions. AID supports State Department objectives but AID officials told us that these objectives can, at times, impede AID's economic reform efforts. In El Salvador, for example, AID disbursed $50 million in ESF in August 1984 without obtaining that government's agreement to exchange a percentage of coffee export proceeds at the parallel exchange rate--an agreement which AID had intended to obtain prior to releasing funds. According to AID officials, this decision was made because El Salvador badly needed foreign exchange and because U.S. security and political objectives compelled provision of assistance to the newly elected government.

Similarly, AID mission and headquarters officials believe that U.S. foreign policy objectives have complicated AID's economic reform and stabilization objectives in Honduras. For example, the President directed provision of $30 million in ESF, disbursed in August 1984, after a personal appeal by Honduran officials, waiving all AID conditions for Honduras to enter into negotiations for a new IMF arrangement. AID officials told us that this action illustrates the difficulty of maintaining rigid economic conditions on assistance when the United States has strong political and security reasons for providing economic support. State Department officials told us the United States cannot rigidly require difficult policy reform at the expense of U.S. foreign policy objectives and that AID's policy reform goals were, in hindsight, optimistic and perhaps unrealistic given the political situation.

In contrast, officials of the Office of Management and Budget told us that AID needs to more forcefully advocate economic policy changes to achieve stabilization. Further, the Treasury Department believes balance-of-payments support should be provided only when a recipient country is willing to undertake a meaningful program of adjustment. Treasury and Office of Management and Budget officials told us they have expressed their views to AID.

AID officials also expressed uncertainty over the extent of congressional support for the agency's macroeconomic reform efforts. The 1984 foreign assistance supplemental legislation and 1985 continuing resolution prohibit AID from restricting "obligation or disbursement solely as a result of the policies of any multilateral institution." In support of this prohibition, the report accompanying the 1984 supplemental appropriation noted that the intent of foreign assistance funds is not to support the IMF but to further U.S. foreign policy objectives. According to the sponsor of this prohibition, it was not meant to discourage AID from seeking economic reforms. However, AID mission and headquarters officials told us that it has been interpreted by some AID and recipient government officials as an absence of congressional support for AID efforts to influence macroeconomic reforms through its ESF assistance.

Some AID mission officials told us they were unaware of explicit statements of congressional views on the importance of economic reforms. Congress has required assessments of a recipient government's human rights policies and reports on a country's support for U.S. foreign policy objectives. However, it has not required such reporting on whether an ESF recipient country's economic policies are consistent with actions that AID believes are necessary for economic stabilization and growth. To demonstrate the impact of congressional views on host-country economic actions, AID told us that El Salvador officials have asked if the administration and the U.S. Congress supported AID macroeconomic conditions.

One senior AID official observed that U.S. agencies needed to agree on a strategy for influencing macroeconomic changes in El Salvador and Honduras, where the United States has strong political and security interests. Agreeing on a strategy, in our opinion, is particularly important in view of the administration's request submitted in fiscal year 1984 for a multi-year authorization for assistance to Central America through fiscal year 1989 to implement the recommendations of the National Bipartisan Commission on Central America. Passage of a multi-year funding authorization would signal a strong U.S. commitment to El Salvador and Honduras. However, if funds are committed without explicit support for economic policy reforms, we believe that recipient governments would have less incentive to conduct meaningful discussions with AID and to implement reforms needed to lessen future dependence on U.S. balance-of-payments support.

DEVELOPING A STRATEGY TO INFLUENCE POLICY CHANGE

We believe it would be useful for U.S. agencies to reach more agreement on the degree to which ESF assistance should be used to bring about changes in economic policies in El Salvador and Honduras. With more agreement, AID and the Department of State would be able to more realistically describe what reforms can and cannot be influenced in requests for appropriations. We also believe that AID should represent a unified U.S. government position on economic policy reform to enhance the agency's credibility with recipient governments. Based on discussions with AID, the following three alternatives represent a range of options available in reaching more agreement on macroeconomic reform.

1. Withhold disbursements unless recipient governments take immediate action on necessary economic reforms. This alternative might maximize AID's leverage over recipient government economic policies. However, in our opinion, it has potentially serious drawbacks. Some reforms could have a destabilizing political effect, and forcing action at the wrong time could jeopardize all U.S. objectives. In addition, El Salvador and Honduras could decide to forego U.S. balance-of-payments support. This could have a negative impact on the countries' economic conditions, thereby defeating the original

economic stability and improvement objectives.

2. Provide ESF balance-of-payments support without attaching economic conditions. This alternative could meet short-term U.S. political and security objectives. However, long-term stability and growth in El Salvador and Honduras will be difficult to achieve without economic reform. Further, without economic adjustments, the United States may have to provide increasing amounts of balance-of-payments support to keep these countries economically stable. According to Treasury comments on our draft report, this alternative can often prevent fiscal or foreign exchange shortfalls from reaching crisis proportions and threatening the stability of the government but will not prevent economic imbalances from deteriorating and causing more severe crises in the near future. Office of Management and Budget comments on our draft report share this viewpoint. They believe that postponing necessary economic reforms can also lead to political instability because future economic crises will be more severe, requiring more radical economic policy solutions.

3. Consistently use ESF assistance to influence macroeconomic reforms in the context of U.S. political and security objectives. This alternative would require reforms when feasible and consistent with other U.S. objectives. AID believes that the objectives of achieving economic and political stability in El Salvador and Honduras are not inconsistent but are mutually dependent. With the support of Congress and other U.S. government agencies, AID officials believe that they could conduct a more meaningful and effective policy dialogue on economic issues. Unity in the U.S. position could reemphasize a commitment to economic development as well as to security and political stability in the region.

If the administration decides that the United States should more actively seek policy reforms with its ESF balance-of-payments support, we believe AID could employ the following means to hasten policy changes within the context of U.S. political and security objectives.

1. **Apply steady and constant pressure on macroeconomic issues.** This can be facilitated by emphasizing on a regular basis the U.S. commitment to implementation of reforms. Creation of an economic working group of high-level U.S. and host-country officials would provide a forum for communicating U.S. commitment. Such a group was formed in Honduras in late 1983 and, according to AID, has met frequently to review economic performance and discuss potential policy reforms. However, this group was not meeting during our fieldwork and according to AID, did not meet for 5 months during the summer of 1984. In commenting on our draft report, Treasury and the Office of Management and Budget said that high-level policy groups were not advisable because they increase U.S. association with sensitive and potentially unpopular actions. Both agencies stressed the importance of providing U.S. assistance within the context of IMF arrangements.

2. **Provide ESF cash transfer assistance in the form of medium-term loans (3 to 5 years, for example) which would be forgiven upon implementation of macroeconomic reforms.** Funds could be disbursed when needed to satisfy U.S. political, security, and short-term economic objectives. Loans could be forgiven when the recipient government takes action on "self-help" reform measures. In this way, disbursements would not be delayed pending implementation of reforms but the recipient country would have an incentive to make the designated reform. This option would require legislation to permit loan forgiveness. El Salvador and Honduras might not be receptive to this option because they currently receive cash grants, and medium-term repayment of loans would be much less concessional than AID's standard loan terms, which generally allow 40 years for repayment. Treasury and the Office of Management and Budget comments on our draft report said that this course of action would be inappropriate as it would postpone the date when the United States and recipient country governments must confront the need for policy reforms. Loan forgiveness provisions, however, could be structured to discourage the postponement of reforms. For example, loan assistance could be provided with the understanding that the loan would be forgiven if action was taken within specified time frames. Therefore, we believe it offers some potential as part of a strategy to help bring about needed reforms, particularly when withholding assistance until specific reforms are taken is deemed not to be feasible.

3. **Provide a portion of ESF assistance through a parallel market.** Currently, ESF dollars are provided to El Salvador and Honduras through an official market, which has overvalued host-country currencies. Providing assistance on the parallel market would increase the cost of foreign exchange to local importers, encourage domestic production, and eliminate U.S. support of an undesirable exchange rate. El Salvador and Honduras might resist this approach because it would gradually erode the official exchange rate.

CONCLUSIONS

AID has sought to influence economic policy reforms in El Salvador and Honduras to promote long-term economic stability and growth and to lessen dependence on U.S. balance-of-payments assistance. Although some policy measures have been taken, AID influence has not resulted in the degree of macroeconomic reform, particularly exchange rate adjustments, which AID believes is necessary to meet U.S. development objectives. Recipient governments' reluctance to adjust their exchange rates and U.S. security and political objectives have complicated AID's efforts to influence economic reform measures.

We recognize the sensitivity of U.S. objectives in Central America and that the United States has important objectives other than macroeconomic policy changes in El Salvador and Honduras. Forcing economic policy changes would be unwise if it caused politically destabilizing effects in these countries. However, from an economic point of view, it is difficult to justify continuing to finance large-scale, balance-of-payments deficits which are caused, in part, by inappropriate macroeconomic policies within the recipient country.

Estimating the costs of future U.S. balance-of-payments support in the absence of reforms could permit a more fully informed discussion of the trade-offs involved. Development of more interagency agreement on the extent to which balance-of-payments assistance should be used to influence reforms within the context of overall U.S. foreign policy objectives would be useful to the Congress as it considers appropriation of assistance funds to El Salvador and Honduras.

We also believe that given the uncertainties on the extent of congressional support for macroeconomic reform efforts, the Congress should provide an explicit statement of the relative importance it attaches to improved host-country economic policies.

RECOMMENDATIONS TO THE ADMINISTRATOR OF AID AND THE SECRETARY OF STATE

We recommend that the Administrator of AID, in consultation with the Secretary of State, make and present to the Congress a detailed analysis of the estimated costs to finance future balance-of-payments deficits in El Salvador and Honduras in the absence of macroeconomic reforms, particularly exchange rate adjustments.

We also recommend that the Secretary of State, in cooperation with the Administrator of AID, initiate interagency discussions to reach more agreement on the degree to which balance-of-payments assistance should be used to influence economic reforms in El Salvador and Honduras. These discussions should include the Department of the Treasury, the Office of Management and Budget, and other agencies, such as the Department of Defense, which have responsibility for U.S. programs in these countries. Results of these discussions should be presented to the Congress.

RECOMMENDATION TO THE CONGRESS

In view of the uncertainties on the extent of congressional support for macroeconomic reform efforts (stemming in part from the legislation which prohibits restricting AID assistance solely as a result of the policies of multilateral institutions), we recommend that the Congress provide an explicit statement of the relative importance it attaches to improved economic policies in these countries.

AGENCY COMMENTS AND OUR EVALUATION

AID commented that macroeconomic policy reform is unquestionably a high-priority U.S. objective but that encouraging macroeconomic reforms involves trade-offs among U.S. security, social, political, and economic objectives. In attempting to foster these multiple objectives, AID frequently agrees to policy adjustments which are less ambitious than desired and sometimes agrees to disbursements despite host-country problems in complying with conditions. AID believes its economic policy reform goals entail profound economic shifts and often unpredictable short-term social impacts and that it is therefore not unreasonable that desired policy changes will not occur according to a planned timetable. Furthermore, AID said that it frequently sets negotiating goals for policy change higher than it realistically expects can be achieved.

AID also commented that the draft report did not give sufficient credit to the economic policy adjustments which have occurred and overemphasized the importance of devaluation and IMF agreements as pre-conditions to assistance. AID reported that the government of El Salvador had shifted additional import and export transactions to a parallel exchange market so that as of March 1985, 42 percent of all imports and exports are being traded at the parallel rate. We revised the report to recognize this policy adjustment and to clarify that AID encourages actions to gradually adjust foreign exchange systems with eventual unification of official and parallel market rates as opposed to insisting on a full devaluation. AID acknowledges that much more needs to be done on adjustments to exchange rates as well as on measures to control fiscal deficits and provide incentives for private investment and trade.

The Department of State commented that macroeconomic reform is a high priority and that basic changes in policies have been obtained in each country because of the "tough" macroeconomic conditions associated with AID's cash transfer assistance. According to State, El Salvador has provided assurances that it will undertake a more comprehensive economic adjustment program by year-end and Honduras has recently reached a "framework understanding" to implement specific reforms and then move on to a comprehensive adjustment program.

In contrast to AID and State comments, the Office of Management and Budget expressed concern that there could be no political stability without economic stability; by providing assistance in the absence of needed reforms, the United States was merely bailing out the recipient countries in the short-term and that as time passes the severity of necessary reforms would increase. Treasury generally agreed with this assessment and commented that AID's balance-of-payments support may have encouraged governments to delay policy reforms.

The Department of the Treasury agreed with our recommendations and the Office of Management and Budget commented that whether and how the United States can influence policy reforms were critical questions in part because of the expanding cash transfer program.

On our recommendation to the Congress on explicitly stating the degree of importance that it attaches to economic reform, State and AID both commented that any such statement should describe the emphasis to be placed on economic change relative to other U.S. foreign policy objectives in these two countries. Regarding our recommendation to assess future costs of financing balance-of-payments deficits, State commented that this would be a useful input to administration policy makers. AID did not comment on this recommendation.

Regarding our recommendation to reach more interagency agreement on using assistance to bring about economic policy changes, State said that there already was a consensus within the administration on the broad objectives of U.S. assistance and that the administration has undertaken measures to reach interagency consensus on using cash transfer assistance to influence economic reforms. For example, it stated that the National Security Council has examined this issue and efforts have been made to increase participation of other agencies in decisions on requiring economic policy changes. State said that follow-up on these activities is continuing and believes, therefore, that additional separate action on our recommendation is not warranted. Comments from the Treasury and the Office of Management and Budget, however, illustrate the diversity of views regarding this issue. The Treasury Department commented that economic reform is not only important to the U.S. aid effort but is the fundamental goal of U.S. aid. The Office of Management and Budget said that postponing economic reform could be as politically destabilizing as withholding aid.

Given this diversity of views and the lack of data on costs to finance future balance-of-payments deficits in the absence of reforms, we believe this recommendation remains valid. Although we have not evaluated the adequacy of State actions to reach more interagency agreement, we believe the results of the interagency discussions, when completed, should be presented to the Congress. The recommendation has been modified to reflect this.

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

ASSISTANT
ADMINISTRATOR

MAR 26 1985

Mr. Frank C. Conahan
Director
National Security and
International Affairs Division
General Accounting Office

Dear Mr. Conahan:

Attached are the Agency for International Development's comments and recommendations on the GAO Draft Report, "Providing Effective Economic Assistance to El Salvador and Honduras: A Formidable Task."

We would like to compliment the GAO team which prepared this report for their thorough and generally insightful consideration of factors relating to absorptive capacity and macro-economic conditionality of our economic assistance programs in El Salvador and Honduras. We also appreciate the objectivity with which our previous, oral statements were taken into account.

We have taken the time to prepare a detailed commentary on some of the issues raised. Some of these comments are provided as factual corrections. Others relate to actions that have taken place since the time of the GAO field visits, with the result that some statements in the draft report are no longer valid. Others seek a fuller, more balanced discussion of the many factors at work on some of the more complicated issues.

Please let us know if you would like to meet to clarify any of the points made in our commentary.

Sincerely,

Victor M. Rivera

Attachment: a/s

GAO note: The underlined page number references in the left margin have been added to correspond to the page numbers in the final report.

SUBJECT: A.I.D. Commentary on the Draft G.A.O. Report -- Providing Effective Economic Assistance to El Salvador and Honduras: A Formidable Task (GAO/NSIAD-85)

A. General Comments:

pp. ii, 16 18 (U) 1. Institutional capacity in Honduras: The discussion of Honduran Government institutional capacity (p.v of the Digest and pp. 28-30) has too much of an "either-or" orientation. The assertion on p. v that "A.I.D. plans to work less with these (Honduran Government) institutions and more with private sector entities" is especially overstated. It suggests that A.I.D. is abandoning its traditional development activities with the Honduran Government because government institutions do not have the capacity to absorb resources. The fact is that A.I.D. will continue to expand its traditional development activities which rely on and seek to strengthen Honduran Government institutions. On the one hand, such traditional development activities are being successfully implemented in Honduras. As the body of the GAO report indicates, project expenditures actually exceeded new project obligations during FY 84. On the other hand, the Honduran economy is led by the private sector, and it makes good sense to channel much of the increased assistance through private sector activities. In short, the U.S. economic strategy regarding the distribution of funds is being directly related to the economic structure of the country.

There is an adequate institutional capacity in selected government agencies to effectively apply additional resources. This is particularly true for Honduran agencies which have developed and proved their capability on earlier A.I.D.-financed projects. Examples are the Ministry of Public Works and Transport which is ably managing the rural roads program; the Ministry of Health which has achieved good results on the primary health care system, malaria control, and oral rehydration therapy; and the Ministry of Education, which after some initial problems, has improved its management of primary school construction, with increased reliance on private contractors to build the schools. There are also limitations. Therefore, as A.I.D. expands the volume of project-financing, we are pursuing a multi-faceted strategy, involving:

- continued reliance on government agencies with demonstrated capacity;
- financing institutional improvements in government agencies with more limited administrative capacity;
- emphasis on simplified project designs and reduced administrative requirements;

shifting of some implementation responsibilities previously carried out by government, e.g., school construction, to private sector contractors;

- increased reliance on private sector managerial and technical competence to carry out development programs in such areas as agricultural research and extension, livestock development, etc.

We recommend that the relevant sections of the draft report be modified to more accurately reflect this balanced approach.

(U) 2. Adequacy of staff in El Salvador: At the time of the G.A.O. field visit, overall workforce capability in our A.I.D. Mission in El Salvador was a key problem. However, the problem is being addressed. As the report accurately states, provision of secure office space is an essential factor. Mission personnel working outside the Embassy compound are being moved to the CONSESA Building. This building offers better security arrangements, which have been further strengthened with U.S.G. financing. The Rural Development Office and Human Resources/ Humanitarian Assistance Office have already been moved to CONSESA. Additional floors are being leased and will become available in March. More significantly, a two-story annex within the Embassy compound, to be completed in August 1985, will help create the additional office space requested.

The A.I.D. Mission is currently building up staff as new office space becomes available. As a result of special steps taken by the A.I.D. Administrator, four of the seven additional U.S. Direct Hire staff recommended by the Workforce Assessment Task Force are already at work in El Salvador, with the others scheduled to arrive over the next few months. These additions will bring U.S. staff from the 29 on board at the time of the GAO team visit in August-September 1984, to a level of 39 on board by August 1985. Total mission staff (USDH, foreign nationals, and contract employees) are being increased from 139 to 179. Overall, the staff additions recommended by the Workforce Assessment Task Force will be made. Further, we will review the adequacy of the augmented workforce on a periodic basis.

pp. 21-25 The statements on page vi of the Digest and pages 34-38 should be modified to take these concrete and positive developments into account. It is no longer valid to state that "the A.I.D. Mission in El Salvador appears to have insufficient staff to oversee its large program" (p. vi).

(U) 3. Priority of Macro-economic Reform: It is incorrect to state that "macroeconomic reform is apparently not a top U.S. priority, given the political and security objective in both
p. iv countries" (p. ix of the Digest). Macro-economic policy reform is unquestionably a high-priority U.S. objective. A.I.D.

regards appropriate economic policies as essential to the objective of economic stabilization and recovery. Accordingly, we have insisted that discussion of and agreement on economic policy be a regular part of our negotiations with the Government of El Salvador and Honduras on balance of payments assistance. The record of those negotiations is full of examples whereby our missions did not request authorization of balance of payments assistance until there was agreement on policy measures, deferred disbursements until there was evidence of satisfactory performance on policy adjustments, and in the case of Honduras, suspended ESF disbursements in late 1983.

At the same time, there are other high-priority U.S. objectives in these two countries which include security, social and economic stability, a political environment in which democratic institutions and processes may be progressively strengthened, and improved performance on human rights. The Kissinger Commission specifically cited these various objectives and the close interaction among them.

At any given time, there are trade-offs among these objectives. What would in isolation appear to be an ideal economic reform agenda is frequently not totally compatible with political, security, and social objectives - nor the decisions of the elected sovereign governments in El Salvador and Honduras. Because of this need to foster multiple objectives, we frequently agree to policy adjustments which are less ambitious than our negotiating agenda and sometimes agree to disbursements despite host country problems in fully complying with one or more conditions. These judgements are carefully made on the basis of the mix of factors at play at any given time.

Our longer-term objective remains an achievable set of economic policies which will provide the framework for sustainable, equitable economic growth. Our negotiating goals are frequently set higher than our realistic expectations for agreement. Yet we believe that goals should pose real challenges; the key is that the goals be recognized and accepted by the recipient government and that we get steady demonstrable progress towards them. Our policy goals usually entail profound economic shifts with difficult and often unpredictable short-term social impacts so that it is not unreasonable that they will not move according to a rigid, pre-specified timetable. Nevertheless, the record shows that substantial adjustments and real progress have been achieved as a result of these negotiations.

(U) 4. <u>Overemphasis on Devaluation and IMF Agreement as Pre-Conditions</u>: The draft report is inconsistent in its treatment of devaluation and an IMF agreement as conditions of

our balance of payments assistance. In numerous sections, the report strongly suggests that devaluation and IMF agreements were explicit objectives or the only really important
p. iii objectives (see pp vii-viii of the Digest).

p. 33 Devaluation: As correctly noted on page 50, "A.I.D. has not specifically conditioned any of its ESF disbursements in El Salvador on a devaluation that would affect all imports and exports". Our agreements with the GOES have been directed towards formalization of the parallel foreign exchange market, progressive increase in the volume of trade which takes place at the parallel market rate, and eventual unification of the two official rates. As a result, the issue has shifted beyond whether or not the rate should be adjusted to how to carry it out and when. This is a remarkable achievement given historic opposition to any kind of exchange rate adjustments, particularly for a country at war.

In Honduras, the A.I.D. Mission has never requested that the Honduran currency be formally devalued. However, the A.I.D. Mission has pointed out to the Government of Honduras that exchange rate adjustment is one potential measure which in conjunction with fiscal and monetary actions is a key component of a strategy to foster greater export competitiveness.

pp.
37-38 Re IMF Agreements: On p. 57, the report accurately describes the potential value of an IMF agreement. However, it should be noted that our discussions regarding FY 84 Supplemental and FY 85 ESF balance of payments assistance have not attempted to make the existence of an IMF agreement a condition of our assistance. Rather, our objective is a macroeconomic policy framework conducive to stabilization and long-term growth which at the same time may facilitate favorable negotiations between the recipient government and the IMF.

(U) 5. Failure to Acknowledge Significant Macro-economic Reforms: The draft report gives little credit to significant economic policy adjustments which have been made by the Governments of El Salvador and Honduras in the context of U.S. balance of payments assistance to the two countries. There is an implicit conclusion that in the absence of an outright
pp. devaluation or an active IMF agreement, policy adjustments
iii, iv actually achieved had little value. (See pp. vii and ix of the
pp. Digest; pp. 48, 52, and 54 of the Report.) In particular, the
32-36 summary chart on p. 53 understates the real accomplishments in each country, and the progress noted in the chart is not backed-up by discussion in the text of the report.

El Salvador: During the year prior to the GAO team's visit, the principal policy objectives were: (A) unification of the exchange rate at a sustainable level or a gradual shift of transactions to the parallel market; (B) a Central Government fiscal deficit that can be covered in a non-inflationary manner; (C) rate changes of public utilities to make them self-sustaining; (D) GOES deposits into the Agrarian reform compensation account to permit the timely servicing of interest and amortization payments as required by law; (E) a GOES review of the credit requirements of small and medium enterprises in the industry and agriculture and increased resources to these sectors; and (F) adequate counterpart funding for A.I.D. financed and high priority IFI projects.

We believe that the GOES has made significant progress as noted below:

Balance of Payments: Movement of $16 million of 1983/84 crop cotton exports to the parallel market and $15 million plus 50 percent of any increase over the previous year's exports from the 1984/85 crop; movement of 80 percent of shrimp export proceeds through the parallel market; and lifting of all restrictions on industrial exports to outside the CACM. Corresponding amounts were shifted on the import side. More significantly, actions by the GOES Monetary Board since the time of the GAO field visit have greatly expanded the volume of trade at parallel market rates. As of March 1985, 42 percent (by value) of all imports and exports are being traded at the parallel rate.

Fiscal: The sales (stamp) tax was doubled in mid-1983, with the increased rates extending through 1985; electric power rates were increased by 40 percent during the first half of 1984; the increase in salaries of its lowest paid public servants was held to 10 percent, and all vacant government positions were abolished. Partial success was achieved in the other goals. GOES deposits allowed partial payment to agrarian reform bondholders; some improvement in credit availability occurred; and counterpart funding was arranged for A.I.D. and other donor projects.

We do not believe that you can characterize the above actions as "little recipient government action". At the most critical, it might be characterized as "incomplete" or "partial" on some of the most difficult policy changes which A.I.D. was encouraging.

<u>Honduras</u>: In association with our balance of payments assistance, the Government of Honduras:

- introduced a fiscal package, with Assembly approval, to increase government revenues and reduce expenditures;

- passed an Export Incentives Law to stimulate growth of Honduran exports;

- imposed a moratorium on central government guarantees of private sector debt and a limitation on additional borrowing by public sector enterprises;

- recently committed itself to several structural adjustments including replacement of government sight bonds with fixed-maturity issues; replacement of current specific tariffs with ad valorem rates; establishing the legal basis for eventual sale of public enterprises; and creation of a special payments mechanism for Honduran exports within Central America.

By citing these achievements in both countries, we are seeking a more balanced discussion in the GAO Report of macro-economic reform efforts, the seriousness with which they are regarded by the U.S. Government, and some real accomplishments which have been closely associated with the on-going dialogue between the U.S. and recipient governments. At the same time, we acknowledge that much more needs to be done on adjustments within the foreign exchange regimes, control of fiscal deficits; incentive structures for private investment, repatriation of capital, and trade expansion, etc.

In this regard, the GAO report would be more helpful if it treated macro-economic reform achievements separately for El Salvador and Honduras rather than generalize about our experience with the two countries. This differentiation should properly credit the GOES for recent actions to expand the coverage of the parallel market.

B. Comments Keyed to Specific Statements in the Draft Report

(U) 1. "A.I.D. and State have been reluctant to condition
p. iv assistance on reforms" (page vii, line 15): We believe this statement is insupportable, per discussion in paragraph A3 above. In El Salvador, for example, it is not that A.I.D. and State have been reluctant to take advantage of cash transfer opportunities or to condition assistance on reforms in El Salvador. In fact, as the report points out we have probably been overly optimistic. We believe that this paragraph should be changed along the following lines "A.I.D. and the Department of State have not been fully successful in achieving economy policy goals within the time frames reflected in planning documents and agreements. Balancing other U.S. policy goals (i.e., political stability, security, etc.), they have not always included desired reforms in assistance agreements and have agreed to disburse funds in several cases when required actions by the governments have not been taken."

(U) 2. "The Government of El Salvador and particularly Honduras have been reluctant to devalue their currencies
p. iv because this action would be politically unpopular" (page ix,

line 3): This statement is no longer accurate regarding El Salvador, given recent actions by the GOES which have moved 42 percent of all imports and exports to the parallel exchange market.

pp. vi, vii (U) 3. "A.I.D.... (should) make and present to Congress a detailed analysis of the costs of future economic assistance to El Salvador and Honduras in the absence of macro-economic reforms" (p. xiv, line 7): The phrase "costs of future economic assistance" should be replaced with "future balance of payments gaps". It should not be assumed that the U.S.G. would have to cover future BOP gaps.

p. vii (U) 4. "(Congress should) provide an explicit statement of the importance it attaches to improved economic policies." (p. ix, line 3): We recommend that the following wording be added to the sentence quoted above: "relative to that which Congress attaches to other, not always complementary objectives especially those of national and regional security and the internal political stability which act to support it."

p. 11 (U) 5. "...currently authorized levels of balance-of-payments support may already exceed the demand for imports of eligible U.S. products" (p. 17, line 18): This has not been a problem for our ESF balance of payments assistance to Honduras. For El Salvador, on December 14, 1984, A.I.D. made Central American countries, including Panama but excluding Nicaragua, eligble source/origin countries for A.I.D. financed imports under the ESF balance of payments program.

p. 11 (U) 6. "...A.I.D. has been considering (1) including goods from Central America countries as eligible imports" (p. 18, line 7): For El Salvador, as noted above, this decision was made on December 14.

p. 12 (U) 7. "(The Central Reserve Bank in El Salvador) requested A.I.D. assistance to mechanize its price-checking procedures" (p. 19, line (9): In October 1984, a 6-person advisory team from Arthur Young and Co. began a technical assistance effort with the Bank's Price Checking Unit. The team is focusing on: (1) coordination between the Price Checking Unit and other Bank exchange control activities; e.g., establishing a computerized linkage between price verification criteria established by the Price Checking Unit and the mechanized processing of form F10 import permits and (2) improvement of the internal operations of the Price Checking Unit; e.g., creation of an electronic data bank which includes all commercial invoices presented to the Bank and development of more precise and detailed criteria and procedures for price verification of medicinal and chemical products.

(U) 8. "The Government of El Salvador has not consistently
p. 13 spent all local currencies as agreed" (p. 20, line 19): The shortfall in GOES expenditures under the 1983 priority package was due to: (1) an inability of the GOES to expend funds under line items in the priority package for projects which could not be implemented because of security and some technical problems; and (2) limited time available for expenditures between the local currency programming exercise (October 1983) and the end of the GOES fiscal year.

The total shortfall in the 1983 priority package was as follows (in thousands of colones):

1983 Priority Package totals	317,413.6	
Actual Expenditures	275,023.3	
Shortfall		42,390.3

A large part of the shortfall can be attributed to the following:

--Only colones 1,094,400 were expended from a total of colonies 15,100,000 allocated for counterpart costs of a road project (north-south highway) financed by the Central American Bank for Economic Integration (CABEI). The project was cancelled because of security problems. The shortfall was colones 14,005,000.

--Only colones 12,666,000 were expended from a total of colonies 23,533,000 allocated for counterpart costs of the San Salvador-San Miguel project financed by CABEI. The shortfall was colones 10,864,200.

--Only colones 21,069,800 were expended from a total of colones 34,831,300 allocated for counterpart costs of a rural roads project financed by the Interamerican Development Bank (IDB). The first phase of the project (now completed) was delayed by technical problems. The shortfall was colones 13,761,500.

--Only colones 465,900 were expected from a total of colones 6,690,000 allocated for counterpart costs of the Coste del Sol highway project financed by CABEI. The project was delayed by both technical problems and violence. The shortfall was colones 6,224,100.

(U) 9. "On three controversial activities -- government Human Rights and Amnesty Commission and elections, local currency expenditures were, according to A.I.D. officials, significantly
p. 13 less than agreed" (p. 20, line 22): The reason that the expenditures were less than agreed was a strong subsequent GOES belief that these activities were over-budgeted given the time period available for implementation. The GOES and A.I.D. only

agreed to allocate funds for these three activities on October 7, 1983, and the GOES fiscal year effectively ended 49 working days later. In late November 1983, an adamant Minister of Finance convinced A.I.D. that funds in these amounts could not be effectively spent during the period remaining in the GOES fiscal year. Instead, he promised to provide funds for these purposes in the 1984 budget when they could be more carefully programmed and administered without time pressures.

Funds were provided as promised for the Human Rights Commision and elections administration. The work of the Amnesty Commission had already terminated.

(U) 10. "At the close of the year, the Government (of El Salvador) notified A.I.D. that it did not have sufficient funds for (compensation of land-owners) but did meet its 1983
p. 13 commitment in mid-1984" (p. 21, line 9): Correction: The funds, which were reserved under and charged to the 1983 budget, were deposited into the compensation fund account on March 15, 1984 rather than mid-1984.

(U) 11. "We did not attempt to determine if controls and distribution procedures were sufficient to prevent food
p. 14 diversion (in El Salvador)" (p. 22, line 26 and top of p. 23) The GAO's discussion of this subject, in its brevity, is misleading; it suggests the possibility of a serious problem that may not have received adequate attention. We supply here a detailed account of management and control procedures on U.S.G. - financed food distribution, either to dismiss the issue or to be incorporated in the discussion of the subject in the GAO Report:

The diversion of Title II food categorically has not been and is not a serious problem in El Salvador. Since the beginning of the conflict in El Salvador in 1979, 66,480 M tons or 132,960,000 million pounds of Title II food valued at approximately $16,620,000 have been donated to the Salvadoran people by the U.S. Government. It would be naive and beyond reason to expect that of these millions of pounds of food, some impoverished recipients would not, as a desperate act, trade or sell a few pounds of this food for an urgently needed necessity. All the distributors and recipients know that this is against regulations and surprisingly few of the needy poor do circumvent the rules. Every time there has been any allegation of the diversion of Title II food the USAID Food for Peace office has acted promptly to determine the validity of the allegation. To date, in all cases, no serious instance of Title II Food diversion has been detected. In most cases, it was simply a matter of non-Title II food being rebagged in used Title II bags. Poor people everywhere tend to save and reuse such items for obvious reasons. Where an actual case of illegal food purchase existed, the guilty party was prosecuted. There is a standing order to all military commanders to investigate and take action against all instances of food misuse in their jurisdictions.

In March 1984, the New York Times referred to the illegal sale of Title II food. The Administrator of A.I.D. immediately dispatched a high level team of investigators to determine the validity of these claims. The results of this investigation determined that there were a few isolated individual sales, but there was no widespread diversion or misuse of Title II foods in El Salvador. Nevertheless, to forestall the possibility of any food diversion USAID/El Salvador initiated a series of actions:

-In April, 1984 a team of seven food supervisors was contracted by USAID to monitor the implementation of all Title II food programs throughout El Salvador. These supervisors have the responsibility of monitoring beneficiary eligibility, doing physical inventories, carrying out market checks to determine if there are illegal slaes of donated foods and determining if the end use of the distributed food is within established program agreements. This team has proven to be highly effective and, as a result, the contract has recently been extended for another year.

-An experienced U.S. Direct hire Food for Peace officer was assigned to USAID/El Salvador in August, 1984 on a permanent basis to coordinate all food assistance programs and to act as advisor to the USAID Mission Director on all PL 480 Title II matters.

-During June-July 1984, management audits were conducted by independent United States and El Salvadoran consulting firms of the two principal GOES agencies, DIDECO and CONADES, responsible for emergency and regular food assistance programs. The ensuing recommendation indicated that there were some logistical, management and transportation deficiencies, primarily due to lack of money. Since then, USAID has agreed to allocate the equivalent of almost one million dollars of U.S. Title I counterpart funds to improve program implementation. In addition, the USAID has assigned management technical assistance teams to these two organizations. The teams have developed a rational commodity delivery system, introduced orderly purchasing procedures, greatly reduced the cost of locally purchased commodities, reorganized regional offices, implemented a vehicle maintenance program and introduced new oversight procedures.

(U) 12. "This type of project assistance often experiences
p. 15 implementation delays and slow disbursement rates" (p. 23, line 26): A more accurate statement would read: "This type of project assistance is staff-intensive, difficult to implement, and relatively slow-disbursing".

(U) 13. "In Honduras, A.I.D. is limiting assistance for
p. 15 institution-strengthening ... (p. 24, line 2): We suggest amending the first part of the sentence to read, "In Honduras, institution building continues to be an important part of the program, but A.I.D. is limiting, etc., etc."

(U) 14. "A.I.D. concluded that the Honduras Government will not be able to fund the maintenance component of education
p. 21 projects as originally planned." (p. 32, line 18): The quoted statement is accurate, but misleading. The strategy eventually worked out by A.I.D. and the MOH is placing a major responsibility for school maintenance on communities where the schools are located rather than the government's assuming the full maintenance cost in perpetuity.

The original design of the Rural Primary Education project contemplated the creation of a nationwide school maintenance program. The program was to have been centralized in the Ministry of Education (MOE) and financed by central government resources.

In early 1984, the maintenance component of the project was redesigned. The geographic scope was changed to include only six departments under this project. More important, the major burden of financing was shifted to the communities where schools were being built.

This new approach has worked very well. A very aggressive MOE leader and a number of trained promoters are helping to shift the financial burden for school maintenance to the communities. Currently, costs are shared by the community and the central government on an equal basis.

(U) 15. "A.I.D. Mission officials (in El Salvador) listed the following examples of actual or potential management problems
p. 23 caused by staff shortages" (p. 35, line 9):

a. "Lack of technical procurement specialist" - a U.S. procurement specialist will be assigned to a regional office based in Guatemala (R.O.C.A.P.) on March 30. This officer will give priority to assisting the A.I.D. Mission in El Salvador with procurement.

b. "A project to strengthen the Education Ministry may not be implemented in 1985 due to a lack of mission staff" - A U.S.Direct Hire education officer will arrive in El Salvador on April 1. In addition, a U.S. education specialist on contract will be added to Mission staff. Accordingly, we are proceeding with a new A.I.D.-financed education project, with obligations planned for FY 1985.

c. "The Controller's Office had only three U.S. direct-hire staff" - The A.I.D. Mission has added one U.S. financial officer on personal services contract (PSC), to its Controller Office. A second U.S. PSC will be added in the next few months.

(U) 16. "Until additional secured workspace is available (in El Salvador) and A.I.D. entices more volunteers or decides to assign staff on a non-voluntary basis, Mission efforts to
pp. 24,25 manage its expanding program will be hindered" (p. 38, line 8): As explained under paragraph A2 above on Adequacy of Staff in El Salvador, this conclusion and the discussion that precedes it are now inaccurate, overtaken by A.I.D. management actions since the time of the G.A.O. field visit.

(U) 17. In El Salvador, "about three-fourths of all exchange
p. 33 transactions must still be conducted at the official rate." (p. 45, line 5): The A.I.D. Mission reports that in November 1984, the Government shifted 42 percent of all imports and 28 percent of all exports to the parallel market and in March 1985, increased the volume to 42 percent of imports and 42 percent of exports, 2 percent more than previously agreed.

(U) 18. "Our analysis shows that A.I.D. ... and State have been reluctant to condition assistance on reforms, have not always included reforms in assistance agreements as planned, and, in several cases, have disbursed funds when required
p. 32 actions had not been taken" (p. 48, line 20): This statement should be modified in light of our previous remarks under sections A3, B1, B8 of this commentary.

(U) 19. "In Honduras, A.I.D. has discussed the need for devaluation with government officials but has not made
p. 33 devaluation a condition of assistance." (p. 50 line 18): This statement would be more accurate if it read, "In Honduras, A.I.D. has discussed the need for exchange rate adjustments with Government officials but has not made formal devaluation a condition of assistance. Rather we have discussed and encouraged them to take a variety of measures to foster greater export competitiveness including the use of a parallel market..."

(U) 20. In Honduras, "A.I.D. resumed assistance in March 1984, waiving the requirement for compliance with IMF conditions".
p. 34 (p. 51, line 24): It should be explicitly recognized here that the Government of Honduras organized a comprehensive fiscal package, composed of tax and expenditure restraint measures. A.I.D. resumed disbursement in expectation of this fiscal package.

deleted (U) 21. "In addition to devaluation and IMF reforms, A.I.D. has also sought to influence other policy actions, with mixed success." (p. 52, line 14): For a fair and balanced treatment of A.I.D.'s efforts in macro-economic reform, some of the more significant adjustments should be discussed here, per our comments under paragraph A5 - Failure to Acknowledge Significant Macro-economic Reforms.

deleted (U) 22. "Although the government had not complied with all of the spending targets, A.I.D. disbursed ESF funds throughout 1983 to support El Salvador economy". (p. 52, line 18): This statement is not completely correct, and should be modified in light of the facts presented under paragraphs B8 and B9, above.

p. 35 (U) 23. "Summary of Macro-economic Reform Progress for El Salvador". (Table on p. 53): For El Salvador, "progress made" portion of this table should be footnoted as follows: in November, this was changed to 42 percent of imports and 28 percent of exports and by March 1985, to 42 percent of imports and exports. The table's notation on economic growth should be modified as follows: "past declines in GDP were arrested in 1983 and in 1984 growth of 1.5 percent is expected".

p. 35 (U) 24. "Summary of Macro-economic Reform Progress for Honduras" (Table on p. 53): For Honduras, objectives under the "Category" column and examples of "Progress made" should be expanded, in accordance with our listing of accomplishments under paragraph A5 above.

p. 36 (U) 25. In El Salvador, "The new government elected in May 1984 has strongly resisted exchange rate adjustments", etc. etc. (p. 55, line 1 through line 14): Again, this paragraph is inaccurate given the GOES' actions to expand trade on the parallel market in December 1984 and March 1985.

p. 43 (U) 26. A high-level economic working group "has been created in Honduras, but it has not met regularly". (p. 64, line 1): With the exception of a hiatus during the summer of 1984, the Joint Economic Working Group (JEWG) in Honduras has met frequently to review economic performance and to discuss the policy reforms which may be implemented in order to improve that performance. Our records show that the JEWG met on 11/23/83, 1/19/84, 3/14/84, 3/26/84, 4/3/84, 5/8/84, 10/9/84, 12/11/84, 12/21/84, 1/22/85, 1/29/85, 1/30/85, 2/1/85, and 2/21/85. The JEWG is the forum through which agreement on the FY 84 Supplemental ESF program was recently negotiated.

p. 44 (U) 27. "Quantifying the costs of future U.S. balance of payments support in the absence of reforms..." (p. 65, line 12 and similar language on p. 66, line 3): more apt phrase would be "quantifying the future balance-of-payments gap". We should not assume that the U.S.G. would take responsibility for financing the entire gap.

United States Department of State

Comptroller

Washington, D.C. 20520

March 25, 1985

Dear Frank:

I am replying to your letter of February 22, 1985 to the Secretary which forwarded copies of the draft report: "Providing Effective Economic Assistance to El Salvador and Honduras: A Formidable Task".

The enclosed comments on this report were prepared in the Bureau of Economic and Business Affairs.

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

Sincerely,

Roger

Roger B. Feldman

Enclosure:
As stated.

Mr. Frank C. Conahan,
Director,
National Security and
International Affairs Division,
U.S. General Accounting Office,
Washington, D.C. 20548

GAO DRAFT REPORT "Providing Effective Economic Assistance to El Salvador and Honduras: A Formidable Task"

In general the draft report appears to be well researched, balanced and accurate. However, a few points of clarification concerning Administration policy and the policy making process do seem warranted.

The Administration has followed a consistent policy regarding the use of ESF for Honduras and El Salvador. Our objectives in these two critical countries are complex:

-- To bolster the democratic process and political stability in order to promote governments that are responsive to the needs of their people;

-- To assist in improving internal security so that countries in the region can withstand the threat of costly external subversion and military invasion; and,

-- To encourage sound macroeconomic policies that will enable Honduras and El Salvador to reach economic equilibrium and self-sustained economic growth in the medium-term.

There is a consensus within the Administration on these broad objectives. Applying them to specific circumstances, however, involves the difficult trade-offs described in the GAO report and naturally gives rise to differences of opinion on tactics. Since such differences exist within as well as across agency lines, it is misleading for the GAO to draw a dichotomy between the views of agencies such as State and AID on this subject. All elements of the Administration continue to give high priority to macroeconomic reform, but not to the exclusion of other priorities. Thus in virtually every instance where the GAO report refers to AID's support for macroeconomic reform and conditionality it would also be appropriate to indicate that State shares that position. The reverse is also true: in cases where the Administration has decided to relax conditionality AID has been actively involved in the decision making and sometimes the chief architect of the proposal. In short, these are Administration, not individual agency, policies and decisions.

The Administration has undertaken economic policy dialogues with the Honduran and Salvadoran governments to promote accelerated adjustment. Basic changes in policies have been obtained in each country, and each country has committed itself to further reforms in large part because of the tough macroeconomic conditionality of our ESF assistance. El Salvador has now moved more trade to the parallel exchange market than is reflected in the GAO report and has assured us that it will undertake a more comprehensive economic program by year end. Honduras has taken steps to hold down its budget deficit and recently initialed with us a framework understanding on a three phase ESF disbursement program which will begin with Honduran government action on certain individual reforms aimed at improving internal and external competitiveness and then move on step-by-step to a comprehensive adjustment program.

Thus considering the complex balance between our various objectives and the sensitivity of these issues in the context of major elections in each country, the Administration's record in pursuing sound macroeconomic policies in El Salvador and Honduras is credible and holds up under scrutiny. The GAO report notes the complexity of these issues and essentially confirms this approach.

The GAO's recommendation that Congress provide the Administration with an explicit statement of the importance which Congress attaches to improved economic policies would be very useful, provided that it is a statement of desired emphasis relative to other US Foreign policy objectives. Contrary to the GAO report's page ix assertion, macroeconomic reform is already "A top US priority." The difficult task we face is not one of assigning an absolute priority to any single US objective but of weighing the relative importance of several priorities and determining how they should be applied in each specific set of circumstances.

Likewise, the recommended assessment of future economic assistance costs in the absence of macroeconomic reforms would also be a useful input to Administration policy makers.

The Administration has already undertaken several measures to achieve the objectives of the GAO report's remaining recommendation concerning development of a clearer interagency consensus on using ESF assistance to influence economic reforms. The National Security Council has examined these policies in the context of Central American economic development. Efforts have also been made to increase the participation of other agencies in the regular AID-chaired Development Assistance Executive Committee (DAEC) reviews of individual country ESF programs, and an ad hoc policy level Foreign Assistance Review Group chaired by State has been activated to review special cases. Appropriate follow-up on these activities is continuing, and separate additional action pursuant to the GAO recommendation is therefore not warranted.

Elinor G. Constable
Acting Assistant Secretary for
Economic and Business Affairs

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

APR 01 1985

RE: GAO472054

Dear Mr. Anderson:

Treasury welcomes the opportunity to comment on the draft GAO report-- "Providing Effective Economic Assistance to El Salvador and Honduras: A Formidable Task." We found the executive summary to be an excellent capsulization of the policy issues in El Salvador and Honduras, and believe that the policy recommendations are correct.

We did have some concerns about the body of the report, and our detailed comments are attached. In particular, Chapter 2 concentrated too heavily on technical administrative issues (especially of project aid) and not enough on the broad economic problems being addressed by U.S. balance of payments support. Chapter 3 should have stated more directly that economic reform is not only important to the U.S. aid effort, but the fundamental goal of U.S. aid. A comprehensive set of reforms supported by the USG, IMF and other creditors is essential to economic and political stability there.

If you need further clarification of Treasury's views on these matters, please let me know.

Sincerely,

David Mulford
Assistant Secretary
International Affairs

Mr. William J. Anderson
Director
U.S. General Accounting Office
Washington, D.C. 20548

Enclosure

GAO note: The underlined page number references in the left margin have been added to correspond to the page numbers in the final report.

Treasury Comments on GAO Report

Chapter 2

General Comments:

Chapter 2 attempts to examine the effectiveness of U.S. aid programming in El Salvador and Honduras, but fails because of an overly narrow focus on technical administration of funds rather than a more fundamental review of the problems being addressed and success in dealing with them.

Balance of payments assistance (cash transfers and food aid) predominates in these countries. This is fast disbursing aid, designed to fill a payments gap, address and hopefully cure the problems that have created the gap, and set the stage for long-term growth and development. The heart of the assessment should therefore be the underlying problems causing the gap and the steps taken to address them. Instead, by focusing narrowly on administration (pipeline, staffing, local currencies), the chapter concentrates excessively on the much smaller project aid portion of U.S. assistance.

To remedy these shortcomings, there should be more discussion of the financing gap and the role of balance of payments assistance. Issues include how the external imbalance relates to present policies and may indicate the need for structural transformation of the economy; what the repercussions of an unfilled gap are; and what different approaches to filling the gap (adjustment or financing) mean in terms of future assistance requirements. Brief consideration of these issues would better set the stage for the discussion in chapter 3. The first full paragraph on p 17 makes some reference to these issues, but is excessively abbreviated.

pp. 11-12 The section on "Foreign Exchange Management" (pp 18-20) should more clearly highlight the perverse results that can occur when USG assistance is used in a context of inappropriate economic policies. In particular, we believe that the intensification of foreign exchange controls and government regulation discussed in this section is largely necessitated by inappropriate policies. Rather than seek to increase government regulation of 26 private sectors, the USG should seek policy reform.

pp. 12-13 The section on "Local Currency Management" (pp 20-21) should draw attention to the dangers of funding recurrent government budget expenditures with the local currency counterpart of external assistance flows.

Specific Comments (changes are underlined):

pp. 24-25 p 37, ¶ 2: . . . can apparently be absorbed. However, the emphasis on quick disbursement of assistance means that the impact of our aid may be limited to filling existing gaps, rather than improving future prospects for self-sustaining economic growth and appropriate public sector activity. As discussed in the next chapter, its ultimate effectiveness in economic terms, therefore, will . . .

Chapter 3

General Comments:

Perhaps because the relationship between our balance of payments assistance and economic prospects and policies is inadequately drawn in Chapter 2, Chapter 3 is somewhat misleading in its description of the relationship of U.S. aid to economic reform. Beyond saying that the effectiveness of U.S. aid in promoting development depends on economic reform, it would be accurate to state that fundamental economic reform is the goal of these U.S assistance programs. This premise should be the basis for discussing how USG assistance, comprehensive economic reform, and the IMF and other multilateral institutions are related.

In addressing the reform issue, the chapter focuses a bit too much on devaluation. While exchange rate adjustments are a central concern, devaluation only makes sense in the context of a comprehensive set of economic adjustment measures covering fiscal and monetary policies as well.

The chapter understates the importance of an IMF program to these countries. The USG believes that the IMF is best equipped to pursue such comprehensive economic reforms, which often involve politically sensitive issues. Furthermore, an IMF program contributes IMF resources and catalyzes financing from other sources, both new money and Paris Club reschedulings, which would be mobilized with a Fund "seal of approval".

Because of the sensitivity of these issues, we do not believe pp. 33-43 that formation of high level policy groups (referred to on pp 50, 63-64), which increases USG association with specific adjustment measures is advisable.

The report notes that in examining problems associated with economic conditionality, AID has raised a subsidiary issue pp. 38-39 of the level of contact between AID and IMF staff (pp 57-58).

Treasury believes this concern is too minor to be included in the discussion of fundamental policy issues to which this chapter is devoted, and in any case, a GAO report should not serve as a forum for a turf battle between agencies. In fact, Treasury has been apprised of AID's concerns and is willing to work with AID to assist its review of IMF programs. We therefore believe these paragraphs should be dropped. If this issue remains in the report, Treasury would want to add the text listed among the specific comments below.

We have an additional problem in that the report tends to put the IMF in a negative light. The report does not make clear

pp. 37-38 (pp 56, 57) that Honduras' program was canceled because Honduras was significantly out of line with the needed adjustments agreed to in the program. On the same pages, the report gives specifics as to prior conditions the IMF would require in any future program. We feel that it is highly inappropriate to second-guess the IMF on the specifics of future IMF policy in a public document.

p. 39 Furthermore, the report urges (p 58) the IMF to send representatives to Honduras and El Salvador to encourage policy reforms. In fact, the IMF has sent and continues to send representatives to consult with these countries.

p. 43 Finally, we do not believe that recommendation # 2, p 64 would be an appropriate course of action. We believe that postponing the date when the USG and recipient countries must confront the need for policy reform is not a responsible approach to the very serious economic difficulties of the region. We further believe that the USG's leverage to obtain policy reform would be greatly diminished once the money is disbursed; we have not noticed a great aversion on the part of most countries to accumulate arrears to the USG. Finally, we believe that a policy which would intentionally increase recipient countries' debt service burden, most likely to insupportable levels, is neither credible or constructive and creates very serious problems for the USG debt policy pursued in the Paris Club and elsewhere.

Specific Comments:

p. 26 p 39, ¶ 1: . . . devalue their currencies and reduce fiscal deficits, because such action . . .

p. 27 p 41, ¶ 1: . . . exports have damaged their economies. Government responses to these adverse external developments have been inadequate at best, and often actually counter-productive. Equally damaging . . .

p. 29 p 42, ¶ 2: . . . assuming no other adjustments. On the negative side, this support, and the higher growth it has supported, may have encouraged governments to delay policy reforms.

p. 29 p 44, ¶ 1: . . . reduce central government deficits, make tax systems more efficient and equitable, and improve incentives . . .

p. 30 p 46, ¶ 1: . . . Honduras may require up to an additional (?) $250 million of balance of payments . . .

p. 36 p 54, second tic: . . .to advise it, and has been reluctant to initiate substantial economic dialogue . . .

p. 37 p 56, ¶ 1: . . . underlying economic rationale. The price of this reluctance to adjust the exchange rate is continued low growth, capital flight and increasing government controls.

p. 38 p 57, ¶ first tic: . . . and then condition USG assistance on compliance with an IMF adjustment program.

p. 39 p 58, ¶ 1: . . . and recommended solutions are seldom discussed in detail. Treasury does not believe that current procedures for contact with the IMF constrain policy dialogue between the Fund and the USG. The USG has ample information on IMF country programming. In Washington the U.S. Executive Director's office arranges extensive briefings for AID staff but requires that all USG contacts with the Fund staff go through the USED's office. This insures that the U.S. presents a unified view and does not complicate an already time sensitive process. To attempt to become any more directly involved in the country negotiating process would threaten the independence of IMF program design, which is essential to the Fund's success.

p. 42 p 63, # 2: . . . This alternative can often prevent fiscal or foreign exchange shortfalls from reaching crisis proportions and threatening the stability of the government. The medium- and long-term consequences of this approach are usually negative. Underlying economic imbalances deteriorate further, increasing dependence on external support and the likelihood of more severe crises in the near future.

APPENDIX IV

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

APR 19 1985

Mr. William J. Anderson
Director
General Government Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Anderson:

This responds to your February 22 letter to OMB Director David Stockman requesting comments on the draft GAO report, "Providing Effective Economic Assistance to El Salvador and Honduras."

The second chapter of the draft report offers a detailed, balanced analysis of how AID administers project assistance to El Salvador and Honduras. As the report notes, however, AID's ability to spend money quickly or to keep track of local currency does not necessarily mean that our economic assistance is effective. In our view, the more critical questions are whether and how the United States can influence the Central American countries to undertake economic policy reforms so that they will be able to sustain growth without ever-increasing levels of donor assistance. The growing financial problems of all developing countries, as well as our expanding cash transfer program, make these questions more relevant now than in previous years. Therefore, the enclosed comments focus largely on Chapter Three of the draft report.

Thank you for the opportunity to review your report.

Sincerely,

Philip A. DuSault
Deputy Associate Director
for International Affairs

Enclosure

"Providing Effective Economic Assistance to El Salvador Honduras: A Formidable Task"

OMB COMMENTS
(GAO REPORT 472054)

- The relationship between economic reform and U.S. political and security objectives of aid to Honduras and El Salvador is more complex than presented in Chapter three. The consequences of postponing economic reform can be as politically destabilizing as withholding aid disbursements. Aid without strings may serve only to "bail out" a country temporarily, so that when it is finally forced to act, the necessary reforms require radical adjustment. For example, violent riots were triggered in the Dominican Republic when price subsidies were abruptly removed. If action had been taken earlier, the subsidies could have gradually been reduced.

- Chapter three should include more discussion on the role of the IMF, how it operates, and the goal of our cash-transfer program. In addition to the reasons already listed, the U.S. supports IMF stabilization programs for the following reasons:

  - The Administration's economic policy viewpoint and the objectives of the IMF are very similar. The prime U.S. aid objective is to help create conditions that will promote self-sustaining growth. The key to such growth is sound LDC economic policies which provide incentives for work, savings, and investment. Both the IMF and the World Bank share these goals. They routinely recommend structural adjustments designed to reduce the size of the public sector and deregulate the economy, through such means as elimination of price controls, subsidies, and investment in state-owned enterprises.

  - Coordinated action by official lenders increases the incentives for countries to follow a stabilization program. The leverage that the United States alone can exercise over delicate economic reform issues is limited.

  - 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. Support for the IMF is the best way to support adoption of market-oriented policies by debtor countries.

IMF programs generally place only temporary constraints on the economy and ensure that self-sustaining growth can resume in the shortest possible time. The IMF seldom directs a country to follow any particular course of action in an economic stabilization agreement; in particular, it does not enforce higher taxes. When a country is seeking a loan from the IMF, it must submit a plan and a budget detailing how it will put its economic house in order. The IMF only specifies "targets" on total spending and borrowing that the country must meet.

The severity of the adjustment is often greater than necessary because LDC governments have ignored IMF advice to undertake reforms at an early stage. Resources provided by the IMF, United States and other donors should help ease rather than delay the adjustment.

- The analysis of project aid, food aid and local currency should be integrated into Chapter Three's discussion of macroeconomic policy reforms. Although each bilateral program may serve a particular purpose, they should be managed in context of a comprehensive economic strategy. Without such an approach, some bilateral aid programs can undermine key reforms. Problems occur, for example, when we extend CCC credits to a country that will not be able to make repayments, when we fund development projects that a country cannot sustain over time without external support, or when local currency requirements of projects exceed government spending ceilings.

- High level economic working groups are a weak replacement for the IMF, and may even be counterproductive in negotiating economic reforms. First, AID has neither the resources nor the expertise of the IMF to identify the necessary economic reforms a country should pursue, or to monitor compliance with the reforms once undertaken. Second, a high level working group runs the risk of being viewed as interfering in a country's internal affairs. For example, the joint economic working group in Honduras is perceived by some Hondurans to be an American forum, whose major purpose is to press for those economic reforms the U.S. believes are important. Consequently, exchange rate devaluation has become a bilateral issue, similar to the issue of training Salvadorans at the regional military training center. On the other hand, the IMF operates under fewer political constraints and is more likely to be viewed as impartial in suggesting policy changes.

- OMB strongly opposes the GAO recommendation to provide ESF cash-transfers in the form of medium-term loans, which would be forgiven upon implementation of macroeconomic reforms. First, following this policy would only increase a country's official debt burden, which would make it more difficult to obtain or comply with an IMF agreement. Second, the option would not allow aid to be disbursed in increments, linked to reforms over time so that the adjustment would be gradual. The "day of reckoning" would only be postponed three to five years from now, when the country's economy may have deteriorated even further. The U.S. decision of whether or not to forgive the loans -- to press for economic conditionality-- would be postponed as well.

Third, if a country has not undertaken significant reforms at the end of the loan period, the balance-of-payments assistance requirements could increase to a level beyond which we could finance. Fourth, the U.S. government would be reluctant to not forgive loans to El Salvador or Honduras in the event they did not implement macroeconomic reforms, because these countries already are burdened by official debt. It is therefore unlikely that this recommendation would offer much of an incentive to those countries to implement difficult reforms.

(472054)

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