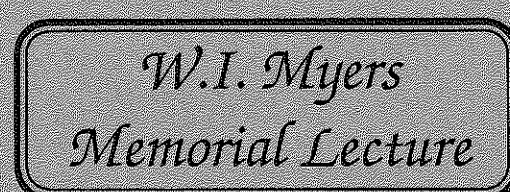


November 1989

A.E. Res. 89-24

# FOREIGN ASSISTANCE AND DOMESTIC FINANCIAL MARKETS IN DEVELOPING COUNTRIES

Claudio Gonzalez-Vega  
Ohio State University

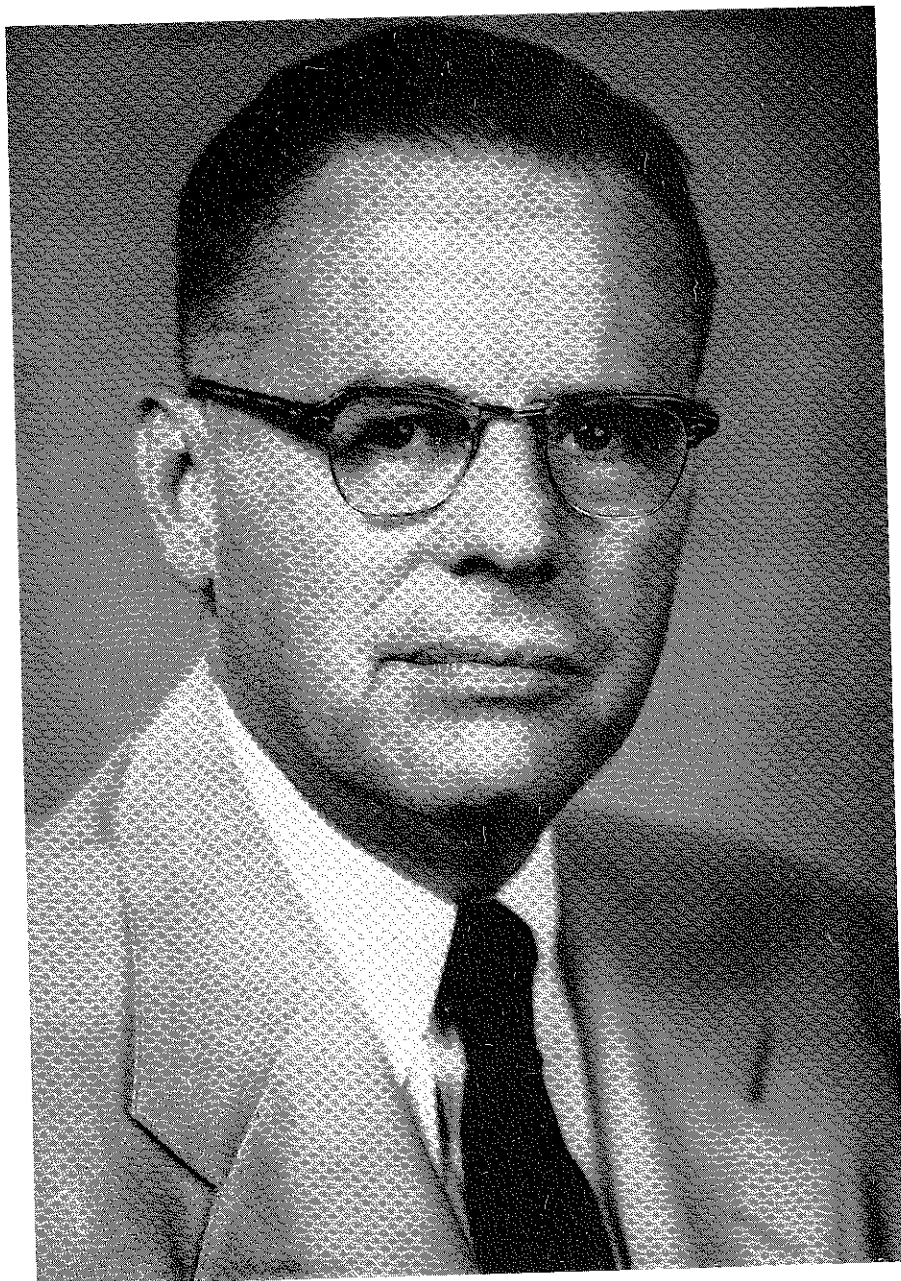


October 4, 1989

Department of Agricultural Economics  
Cornell University Agricultural Experiment Station  
New York State College of Agriculture and Life Sciences  
A Statutory College of the State University  
Cornell University, Ithaca, New York 14853



It is the policy of Cornell University actively to support equality of educational and employment opportunity. No person shall be denied admission to any educational program or activity or be denied employment on the basis of any legally prohibited discrimination involving, but not limited to, such factors as race, color, creed, religion, national or ethnic origin, sex, age or handicap. The University is committed to the maintenance of affirmative action programs which will assure the continuation of such equality of opportunity.



William I. Myers (1891-1976) was one of the early agricultural economists who worked on problems of agricultural finance. He was appointed a full professor of farm finance at Cornell University in 1920. In 1932, Professor Myers was asked to prepare recommendations for a legislative program to solve the agricultural finance problems of those times. His proposals found approval from President-elect Roosevelt, and his ideas formed the foundation for the creation of the Farm Credit Administration and the present Federal Cooperative Farm Credit System. Then, at the request of President Roosevelt, he was granted a leave of absence from Cornell in March 1933 to serve as assistant to Henry Morgenthau, then chairman of the Federal Farm Board. Morgenthau was appointed the first governor of FCA, and Myers became Deputy Governor. Then, when Morgenthau became Secretary of the Treasury in September 1933, Myers was appointed governor of the Farm Credit Administration. He served in that capacity until 1938 when he returned to Cornell University as head of the Department of Agricultural Economics. In 1943, he became Dean of the College of Agriculture serving until 1959.

The purpose of the W. I. Myers Memorial Lecture is to bring to this campus an outstanding agricultural finance economist to lecture on a timely topic. The lecture is sponsored by the Cornell University Department of Agricultural Economics as a part of its continuing emphasis in agricultural finance.



## Abstract

This paper explores the impact of foreign financial assistance on the promotion of domestic financial markets in the developing countries. It claims that the disbursing of large amounts of foreign aid may be a more complex exercise than is usually recognized. The paper reviews the debate on the impact of foreign financial assistance on domestic savings flows and on the efficiency of investment. It explores the role of financial markets in economic growth and the elements of efforts to promote the development of those markets. Finally, it examines the role of foreign inflows in the process of adjustment to external shocks. From a new political-economy perspective, that explains fiscal crises in terms of the accumulation of entitlements to income transfers, it claims that the elasticities of response to adjustment programs are not independent of the amount of foreign aid received. By bailing governments out, aid allows otherwise unsustainable entitlements and distortions. The concepts are illustrated with a review of the Central American experience in the early 1980s.

# FOREIGN ASSISTANCE AND DOMESTIC FINANCIAL MARKETS IN THE DEVELOPING COUNTRIES\*

Claudio Gonzalez-Vega\*\*

## Introduction

During most of the 1980s, Costa Rica, as well as its Central American and Caribbean neighbors, have been in the midst of an acute financial and economic crisis, characterized by a stagnant and at times contracting output (GDP); by an even more rapid decline of their international trade, with sluggish export growth and a sharp reduction in their imports; by unemployment and underemployment well above their historical levels; by huge public-sector budget deficits and the corresponding growth of their public external borrowing, followed by their inability to service this debt as it was originally contracted; by accelerating, either repressed or open inflation, and by the accompanying, explicit or implicit devaluation of their domestic currencies.<sup>1</sup>

These difficulties have been in sharp contrast with the record of rapid economic growth of the previous two decades, particularly after the creation of the Central American Common Market, and with an even more spectacular record of domestic price and exchange rate stability, that had lasted for several decades. These difficulties generated the worst economic crisis that this region of the world has experienced since the Great Depression of the 1930s, when a sharp decline in the international demand for and in the price of coffee and bananas, the area's main export crops, coupled with a substantial increase in the real value of the service of their external debt, severely impoverished these countries.

Last year, in examining the farm debt crisis of the 1980s in the United States, for his Myers Memorial lecture, Neil E. Harl attempted to derive some lessons from that experience, which could help to prevent its reoccurring or, at least, help to cope with the accompanying trauma. <sup>2</sup> The experience of Costa Rica and of many other developing countries during the 1980s may offer lessons of interest, as well, as long as the essential similarities and major differences between the two episodes are kept in mind.

### Foreign Assistance Programs

Political turmoil, insurrection, and the doubtful prospects for long-term peace in Central America have attracted considerable international attention. Since economic stagnation and instability have been major dimensions of the recent history of the region, as well, it is not surprising that numerous plans and programs have been proposed to deal with these problems.

The most common set of responses has been to request, on the one hand, and to offer, on the other, substantially increased flows of foreign financial assistance. As a key example, in mid-1983 President Reagan established a National Bipartisan Commission on Central America, headed by Dr. Henry Kissinger, to propose elements of a long-term United States strategy for the region. In its 1984 Report, the Commission recommended greatly expanded economic assistance. Legislation, known as the Central American Initiative, was then passed authorizing \$ 8.4 billion in bilateral assistance for the fiscal years 1984-1989. <sup>3</sup>

Although the Commission recognized that "large-scale economic aid alone does not guarantee progress," and that "the effectiveness of increased economic assistance will depend on the economic policies of the Central American countries themselves," in practice

the major legacy of the Commission has been the significantly increased flows of financial aid granted during these five years. <sup>4</sup>

The disbursing of large amounts of foreign financial aid may be a far more complex and difficult exercise than is usually recognized. A major question is the extent to which foreign aid and international financial flows, in general, can contribute to growth and stability in the developing nations. This is not an easy question to answer.

The success of the Marshall Plan in the late 1940s and in the 1950s led many to believe that similar transfers of funds to the developing countries would permit their comparably spectacular transformation. It is thus not surprising to observe, for example, periodic calls for a "Marshall Plan for Central America." The optimism inherent in this view has been gradually replaced, however, by a better understanding of the complexities of the process of economic development. At the other end of the spectrum, a few economists have actually claimed that the absence of foreign aid is almost a prerequisite for economic progress in the developing countries. <sup>5</sup>

#### **Financial Assistance and Economic Growth**

In the early days, emphasis on the role of foreign financial assistance was based on the implicit assumption that the key input in the process of economic growth was physical capital and that a shortage of investment, as a consequence of low domestic savings rates, was the critical bottleneck in the process of economic development. <sup>6</sup>

The validity of the presumption of a positive association between the volume of capital inflows and the rate of economic growth in the developing countries has not been demonstrated, however. The assumption has been that the foreign resources would add to the domestic savings, in order to increase total investment. Some of the available

empirical evidence shows, nevertheless, a negative relationship between the inflows of foreign financial assistance and the share of domestic savings in the gross domestic product.<sup>7</sup>

In effect, the foreign funds have frequently substituted for domestic savings, increasing both consumption levels and the extent of capital flight. The additionality of these foreign funds has thus been low. This should not be surprising, given the fungibility of funds and a marginal propensity to save of less than one. Inevitably, given the foreign financial inflows, the recipients will allocate the extra resources partly for present and partly for future consumption. The extent of this leakage into consumption may be considerable, particularly when domestic incentives to save are distorted.

Because funds are fungible, they have the effect of freeing resources for other uses and, as a result, actual changes in marginal resource allocation do not correspond to the intentions of the foreign aid program.<sup>8</sup> Moreover, even if the foreign funds were used solely for a productive investment project that otherwise would not have been undertaken, future income and future wealth would rise and hence savings out of current measured income would fall.<sup>9</sup>

Furthermore, as economic agents see foreign debt rise, they may well anticipate increased future tax burdens for its servicing and they will, therefore, have incentives to transfer assets abroad. A most striking example of this behavior is the extent to which, in several of the large debtor countries, private capital outflows have eroded the net inflows. It has been estimated that up to a half or more of the increase in the gross indebtedness of Argentina, Mexico, and Venezuela during 1974-1982 was offset by private capital outflows.<sup>10</sup>



These capital outflows mean that borrowing by these countries added much less to domestic resources than was originally thought. In effect, in the 1980s, domestic fixed capital formation actually declined in the major Latin American countries. Moreover, since funds invested abroad usually escape the tax base of the borrowing-country government, these outflows have increased the cost to these countries of raising revenue to service their debt and have thus reduced their prospects for debt repayment.<sup>11</sup>

The link of foreign financial assistance with the rate of economic growth through the levels of savings and investment may thus be weak. Of greater concern, moreover, is the impact of foreign aid on the efficiency of domestic resource allocation. Foreign aid flows, for example, tend to overvalue the domestic currency and thereby have a negative impact on the competitiveness of the country's exports.<sup>12</sup>

It has been claimed, in addition, that government-to-government aid can easily contribute to unproductive investment and to the perpetuation of interventionist economic policies that increase capital-output ratios. A leading Guatemalan wrote for the Wall Street Journal that "the combination of have-money-must-lend international institutions and of spendthrift politicians has been one of the main causes of the sad state of economic affairs in Latin America."<sup>13</sup>

This is not the place, however, to explore the causes of the wealth of nations or the complexities of the process of economic development. Since the time of the Marshall Plan, nevertheless, our understanding of the development process has deepened significantly, beyond the view of physical capital as the main input lacking for economic growth in the developing world. Current thinking places equal emphasis on human capital formation, on well-functioning markets, and on the role of international trade, of

entrepreneurship, of technological innovations, and of policies that encourage competition, for increased efficiency and growth. Financial deepening is also highlighted as a determinant of economic growth.

What matters is the accumulation of resources, in both a quantitative and a qualitative sense, as well as an increased efficiency in resource use, from the economic, managerial, and engineering perspectives. Achievement of these goals depends on many factors, including the incentives facing individuals for the accumulation and efficient use of resources as well as the development and improvement of markets, through the promotion of the public and private institutional frameworks (property rights, contracts, market networks), government provision of infrastructural services and public goods (such as agricultural research and extension services), and the removal of the government-imposed impediments to economic efficiency, including the set of price interventions and regulations that drive a wedge between private and social profitability.<sup>14</sup>

### **Financial Deepening and Economic Development**

Following the seminal work of Edward S. Shaw, Ronald I. McKinnon, and their followers, the role of the financial system and the nature of its contributions to economic growth have received increasing attention.<sup>15</sup> These contributions can be associated with the provision of at least four types of services. The most basic is the monetization of the economy; that is, the provision of a means of payments.

Monetization services reduce the costs of conducting transactions in the markets for commodities and for factors of production, increase the flow of trade, and enlarge market size. In turn, through specialization and the division of labor, greater

competition, the use of modern technologies, and the exploitation of economies of scope and of economies scale, these effects increase the productivity of available resources.

The efficiency of the monetization effort is reduced by inflation and by currency substitution (dollarization). In order to avoid the negative impact of the inflation tax, economic agents substitute tangible assets (real estate, inventories, jewelry) and foreign currencies for the domestic money. The domestic currency is no longer considered to be an efficient medium of exchange and store of value. The funds shifted into inflation hedges provide limited social returns, however. Correct macroeconomic management, in order to avoid inflation, is thus crucial for the adequate monetization of a developing economy.

The financial system provides services of intermediation between savers and investors, thus enhancing the accumulation of capital and improving its allocation. In the absence of financial markets, many producers are condemned to take advantage of their productive opportunities only to the extent allowed by their own endowment of resources. In other cases, when their resources are abundant compared to their productive options, savers are forced to invest those resources at low, private and social, marginal rates of return.

There is no reason to expect that those with the capacity to save, at a given moment, are necessarily those with the best investment opportunities. By making the division of labor between savers and investors possible, financial intermediaries channel resources from producers, activities, and regions with a limited growth potential and poor productive opportunities, to those where a more rapid expansion of output is possible.

Through the provision of intermediation services, therefore, the financial system not only promotes productive uses of resources, but it also contributes to the elimination of inferior uses of resources. This is accomplished when the financial system offers wealthholders new assets (for example, bank deposits) that are more attractive forms of holding wealth than the less profitable uses of resources thereby eliminated. The intermediary, in turn, transfers these claims on resources to others, who possess better investment opportunities. From this perspective, the financial system offers valuable services and income-increasing opportunities not only to borrowers, but also to depositors.

Financial policies must create a balance, therefore, between the incentives offered to depositors (to attract their savings) and those offered to borrowers (to promote investment). Many credit programs and institutions in the Central American and other developing countries have relied heavily upon international donor funds, government transfers, and central bank rediscounting for their lending programs, thus ignoring the provision of deposit services.

The financial system facilitates the pooling, pricing, and exchanging of risk and the management of liquidity and reserves. Most economic agents accumulate stores of value for emergencies or to take advantage of future investment opportunities. In the absence of attractive domestic financial assets, they are forced to hold foreign currencies, real estate, and other tangible assets (livestock, inventories, jewelry) that yield low social returns. The financial system reduces the costs and risks of holding precautionary and speculative reserves when it offers attractive forms of holding wealth. At the same time, it reduces the size of the required reserves, provided that it offers unused open lines of credit when needed, and thus releases resources for immediately productive uses. <sup>16</sup>



Finally, the financial system provides services of fiscal support for the public sector. This is an important contribution in the developing countries, in view of weak tax systems and of the absence of markets for securities, where governments could place their paper. While the first three functions (monetization, intermediation, and risk pooling and reserve management) are complementary, this fiscal function of the financial system may be in conflict with the former three. When abused, this fiscal role may lead to inflation, devaluation, and the crowding out of the private sector from domestic credit portfolios. When this happens, the financial system ceases to be an intermediary between private savers and investors and it becomes a fiscal instrument to tax resources away from depositors, in order to finance the public-sector's current expenditures.<sup>17</sup>

In summary, economic development depends upon the growth and diversification of the financial system. Financial deepening matters to the extent to which it integrates markets, provides incentives for savings and investment, encourages savers to hold a larger proportion of their wealth in the form of domestic financial assets, rather than in unproductive inflation hedges, foreign assets, and other money substitutes; and channels resources away from low-return towards better alternative uses.

The financial sector draws labor and other factors of production away from other uses. Its operations thus have a high opportunity cost, justified only to the extent to which the financial services produced increase the productivity of other available resources. The extent to which these services are provided depends upon the size of the financial system in real terms; that is, on the purchasing power of domestic financial assets. It also depends on the efficiency of its performance, as measured by the

magnitude and dispersion of the transactions costs that are imposed on all market participants, actual and potential.

Market fragmentation, the small size of the transactions, the high costs of information, and risk and uncertainty increase the costs of financial transactions in the developing countries. As a result, the net returns to depositors are low, the total costs of the funds to borrowers (including their non-interest expenses) are high, the size of financial markets is small, the volume of the funds channelled and the variety of the services provided are limited, and time horizons are short. Wide intermediation margins are not sufficient to cover the costs of most financial institutions.

Financial progress in the developing countries requires a reduction of these risks and transactions costs, through greater competition and market integration, the exploitation of economies of scale and of economies of scope, professional portfolio management and portfolio diversification, the accumulation of information, and the establishment of bank-customer relationships. Financial progress thus requires a hospitable regulatory and macroeconomic policy environment, viable institutions, and innovations in financial technology, in order to reduce risks and transactions costs.<sup>18</sup>

After the new international development organizations were established in the early post-war years, domestic development banks and special credit programs were created in the developing countries, in order to facilitate the channelling of foreign savings towards target groups and for specific purposes. Although these institutions were introduced in an attempt to bypass domestic financial repression, they contributed little to alleviate it. Rather, in many instances they actually increased market fragmentation

as well as the transaction costs imposed on all market participants in the developing countries.<sup>19</sup>

Development financial institutions have not, on any significant scale, mobilized deposits or provided any other financial services except for the disbursement of loans, usually at below-market interest rates, for a narrow range of uses. They have been incomplete, truncated financial institutions, merely "lending windows" for international donors and domestic governments, to disburse loans at terms and conditions imposed from outside.

Dependency on foreign and government funds, with the accompanying political intrusion, have seriously undermined their institutional viability. Financial services of poor quality as well as high transaction costs, due to targeting and non-price rationing, have not attracted a loyal clientele; arrears and default have represented substantial portions of their portfolios. Their very limited degree of portfolio diversification has further contributed to the high risks assumed and to their eventual insolvency.

These development financial institutions have been a major example of the negative impact of foreign financial assistance on the development of domestic financial markets. By offering cheap loans, but not deposit facilities, they have ignored the important role of intermediation. Their dependence on external funds has limited their access to market information and it has prevented the development of bank-customer relationships, essential for efficient portfolio management. As a result, they have been perceived as "benevolent intrusions to be exploited."<sup>20</sup> They have not survived the recent financial crises.

### Crisis and Foreign Financial Assistance

The economic experience of the Central American and of other developing countries during the late 1970s and early 1980s has been dominated by large external shocks and the accompanying balance of payments crises. Major examples were the two oil shocks and the coffee boom of the 1970s, followed by the world recession of the early 1980s. Usually, such crises have necessitated a reduction in the level of aggregate current expenditures.

The traditional view in these cases has been that, if the proper stabilization-and-adjustment measures are undertaken, the country may be able to obtain additional foreign financial assistance, as well as other resource inflows, which could allow a gradual, rather than a sudden reduction in real expenditures. Under the assumption of concave adjustment costs, orthodox economic theory can show that, with any rate of social time preference greater than the cost of foreign borrowing, the gradual approach, when it is feasible, must dominate any sudden shock treatment. That is, it may be possible to alleviate the crisis by persuading foreign creditors to extend more credit and foreign donors to provide more aid.<sup>21</sup>

The critical question is to determine, therefore, how quickly any country should adjust after it experiences an adverse external shock, such as a major deterioration in its international terms of trade, that results in a balance of payments that is not sustainable in the medium term. As one option, the country can attempt to close the gap rather quickly, with strong contractionary policies and rapid exchange-rate devaluation. If the elasticity of response of the tradable sector is low in the short run, most of the adjustment will have to come from the contractionary policies and from reduced



consumption. The orthodox view in this case is that it would pay the country to borrow during the first years, when foreign exchange is scarce, against the medium term, when the adjustment to the new external situation has taken place, and in this way choose a less costly transition path.<sup>22</sup>

Because time is required for the movement of productive factors and of consumption patterns, the short-term effect of the shock will be an overshooting of the value of foreign exchange, in comparison to its new long-term equilibrium level. If the economy were to adjust instantaneously to the new equilibrium value of the exchange rate, there would be no justification for the extra borrowing. If that is not the case, it would then pay to borrow during the first years of the transition after the shock, against the period when the scarcity price of foreign exchange is lower, because the full resource and demand reallocations have already taken place. This more gradual approach to close the deficit thus requires extra external borrowing (or foreign aid).

This is represented in Figure 1, adapted from Martin and Selowsky. The left-hand side depicts the market for foreign exchange, where  $E_0$  is the equilibrium exchange rate before the shock.  $S_1$  and  $D_1$  reflect the short-run supply and demand for foreign exchange immediately after the shock. If the excess demand for foreign exchange were to be immediately closed, the new market rate would be  $E_3$ . Because that is not the case, the new short-term rate will be at  $E_1$ . As resources are reallocated, both supply and demand increase their elasticity of response, gradually rotating around the original level of the exchange rate, until the long-term equilibrium is achieved at  $E_3$ . External borrowing would make it possible to smooth out the path of adjustment, as shown on the right-hand side of Figure 1. This path depends on the speed at which resources move. Borrowing is equivalent, in this case, to higher elasticities of response.

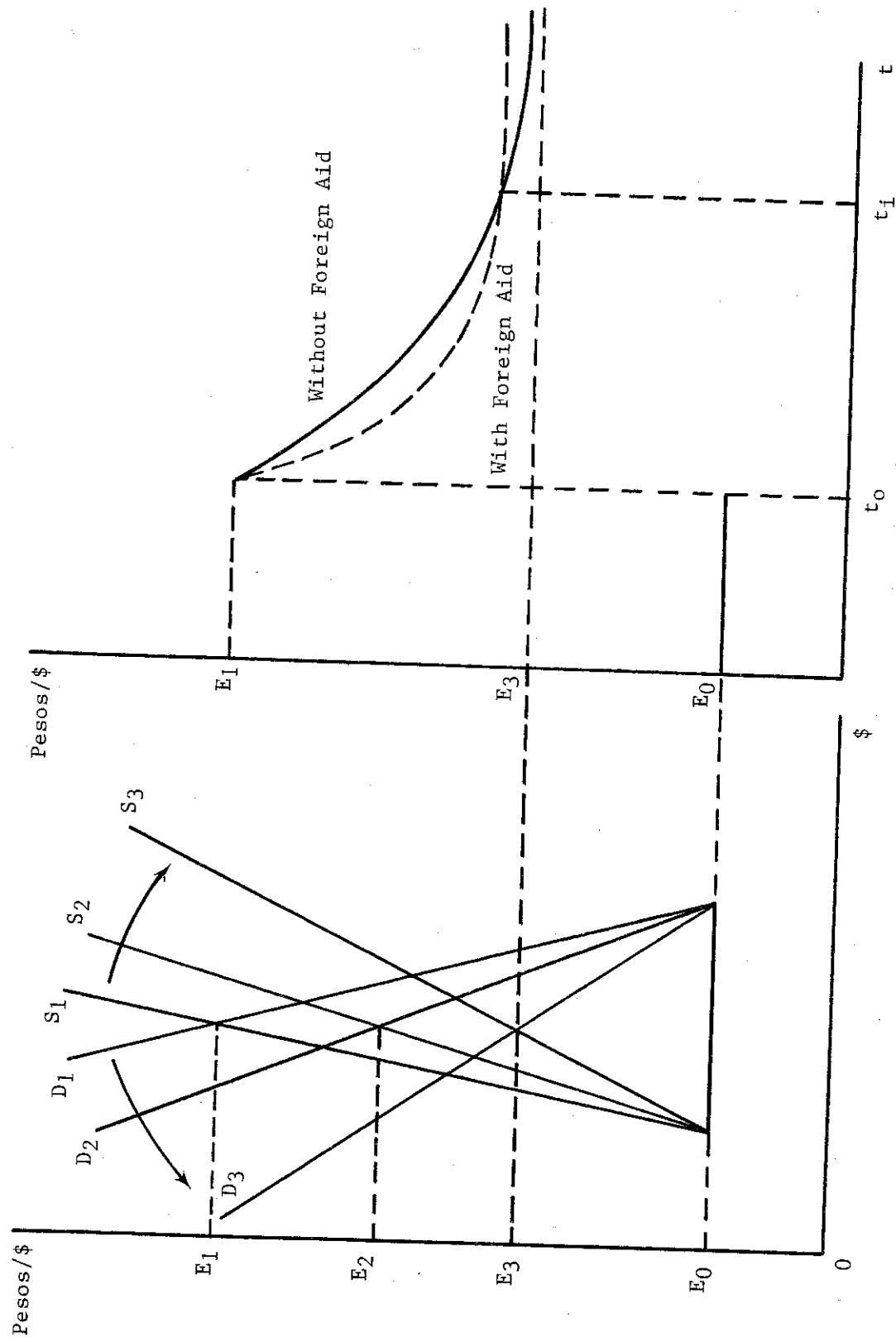


FIGURE 1: Exchange-Rate Adjustment After an External Shock.  
Adapted from Martin and Selowsky.

The key implicit assumption of this analysis is, however, that changes in the elasticity of supply and demand are **exogenous** and only a function of time. Therefore, when the extra borrowing evens out the path of the exchange rate, it is assumed that this smoothing does not affect the speed at which the short-run values converge to the long-run equilibrium levels. The increase in the elasticity of response is assumed to be independent of the path of prices or of prevailing incentives. Concern with the impact of foreign financial assistance, on the other hand, grows out from the perception that these elasticities are **endogenous** and that they may tend to decline with the inflows of foreign funds.

### The Political Economy of Balance of Payments Crises

Once the endogeneity of the elasticities of response is recognized, ample access to foreign financial assistance during a balance-of-payments crisis may not necessarily be welfare improving. To show this, it becomes necessary to explore the origin and nature of the crisis, as well as the behavior of the authorities and the behavior of private economic agents during the process of adjustment, in a political economy context.

Orthodox neoclassical economic analysis assumes disembodied, altruistic policymakers, who maximize a social welfare function, subject to the usual resource and technological constraints. By contrast, the new political economy approaches view the state as composed of clusters of self-regarding individuals and groups, interacting strategically with other private agents.<sup>23</sup> Economic policies then reflect some combination of the objectives of the policymakers themselves and the objectives of vested-interest groups organized to exercise pressure over the policymakers, weighted by their relative political strength.<sup>24</sup>

Most balance of payments crises are in large part crises of the public sector and reflect misjudgements about the appropriate and feasible size and composition of the state. They may reflect excess absorption generated by monetary expansion accompanying government expenditure during the political cycle.<sup>25</sup> They may also reflect an increase in government expenditures that is unsustainable over the long run. This will occur if the government misjudges the size of future annual foreign exchange flows that result from a positive shock, such as the coffee boom, and commits itself to unsustainable consumption-support programs, which would need to be cut back if there were any falling off in the expected foreign exchange rents.

Crises may also reflect the creation of politically-determined entitlements to current and future income streams for various groups in the economy, such as tax holidays for protected manufactures, subsidized credit for small farmers, food subsidies for low-income households, and above-market wages for public-sector employees. The gradual expansion of these politically-determined entitlements creates specific "property rights." These entitlements are difficult to eliminate; they can be removed only at a high political cost. Since they represent explicit or implicit subsidies to particular groups, that have to be paid for by explicit or implicit taxation of other groups. Given very inelastic public-sector revenues, these expenditure commitments lead to fiscal deficits that become chronic. These deficits can only be financed by foreign borrowing, domestic borrowing, or the levying of the inflation tax.

The Central American countries have tried all three methods of financing a growing public sector, with dire consequences. Domestic borrowing to close the fiscal gap has crowded out private investment in credit portfolios and has reduced the rate of



growth of income. Inflation has repressed the domestic financial system, which has shrunk due to currency substitution and other mechanisms of inflation tax avoidance. Financing the deficit with foreign savings was the preferred strategy in the mid-1970s, when international credit was abundant and real interest rates were low and even negative. Many believed that this was a costless method for financing public-sector deficits.

The ability of these countries to service this external debt declined, however, when world real interest rates rose, while their ability to generate the required fiscal and trade surpluses to service the debt was limited both by an unfavorable international environment and by distorting domestic policies, characterized by the strong anti-export bias that resulted from the protectionist import-substitution industrialization strategies adopted earlier. When foreign lending abruptly ceased in the early 1980s, the chronic fiscal imbalance became a financial crisis. This was the case in Costa Rica and in the other Central American nations.

Promotion of manufacturing in the context of the Central American Common Market initially accelerated growth in the mid-1960s, as a result of increased trade. By the mid-1970s, the easy stages of import substitution had been exhausted, new exports had been discouraged, distortions had slowed down the growth of productivity, the accumulation of entitlements had added to existing distortions, while decentralized public-sector agencies became pressure groups in their own right and claimed substantial shares of available resources.<sup>26</sup>

The difficulties brought about by the first oil shock were soon overcome through accelerating foreign borrowing, followed almost immediately by the coffee boom. Coffee

prices quadrupled. Costa Rica's international terms of trade, for example, increased 45 percent between 1975 and 1977. Real aggregate income increased rapidly. Accelerating foreign borrowing, on top of the extraordinary expansion of export earnings, substantially increased all categories of spending. With the euphoria, consumption and imports grew rapidly, while public-sector spending grew even more quickly, beyond levels that could be sustained under normal circumstances, much less during the recession that followed.

Last year, Neil Harl warned about "decisionmakers that can be lulled into economic complacency and confidence by forces that appear permanent but are clearly not sustainable."<sup>27</sup> He attributed this tendency to psychological biases in favor of good news. Political economy forces may explain this behavior, as well. The coffee boom created new opportunities for the proliferation of politically-determined entitlements, granted by short-sighted politicians, mostly interested in their short-term prospects for re-election.

At the end of the coffee boom, with a deterioration of these countries' international terms of trade, and a world recession that required major adjustments, the authorities found it difficult to bring the rate of growth of spending downwards, to a level consistent with the new circumstances. In Costa Rica, the powerful manufacturing sector, extremely dependent on imported inputs, was prepared to block constraints on imports, in order to defend its entitlements. Strong public-sector unions were ready to block attempts at fiscal austerity. The authorities thus chose to postpone the adjustment, by heavily borrowing abroad. When foreign inflows dried up, inflation and devaluation followed.<sup>28</sup>

During the early stages of the crisis, the reduction in the economy's real income necessitated the adoption of expenditure-reducing policies, a mild devaluation, and a reduction of the fiscal deficit. The authorities choose to transform the fiscal deficit into a foreign debt issue, instead. This decision compromised future growth, for the sake of sustaining an artificial level of consumption for a few years more.

Access to foreign savings strengthened the reluctance of the authorities to devalue, even when the domestic currency had become highly overvalued. As a result, those with access to the scarce foreign exchange enjoyed a valuable entitlement. In the end, this was a subsidy for the massive capital flight that took place. The returns from the externally borrowed resources were thereby privatized, while service of the foreign debt was socialized. Indeed, the public sector has been forced in recent years to cut back on the supply of basic services, in order to amortize and pay interest on this debt.

### Conclusion

Under ideal circumstances, foreign financial assistance has added to domestic savings and has thus contributed to economic growth in the developing countries. Under less ideal circumstances, the foreign funds may have sustained growth-reducing policies in many countries. These foreign transfers may have made it possible for too large and bureaucratic public sectors to come about. In extreme cases, this assistance may have made it possible for the public sector to enter into productive activities, better left to the discipline of the market, in direct competition with existing or potential private investors. Financed with foreign savings, these state-owned enterprises may have severely crowded out private firms in credit portfolios and in access to specific resources. Characterized

by high capital-output ratios, these productive ventures of the public sector had added little to social profitability.

In particular, abundant foreign financial assistance may have neutralized the healthy impact of crises on the evolution of economic policies. By bailing governments out, foreign aid has allowed the persistence of unsustainable entitlements and distorting policies; foreign aid has made possible the postponement of the eventual day of reckoning. Postponement of the necessary and inevitable adjustment has actually increased, rather than reduced, the social costs of a vulnerability to external shocks.

What is important to recognize is that the nature and extent of the macro-economic stabilization and policy adjustment programs, made inevitable by a crisis, is not independent from the amounts of foreign aid that become available. Too much aid weakens the will for reform.

Most of the plans and programs for economic recovery in Central America have assigned no active role to the domestic financial systems. At best, the local financial intermediaries have been perceived as convenient conduits to channel foreign funds, in order to take advantage of existing institutions and of established networks of bank branches. Domestic deposit mobilization has been ignored, and most likely discouraged by cheap foreign funds. Too much concessional financial assistance takes incentives to mobilize domestic savings away. Too much foreign assistance may make it possible to postpone overdue reforms, needed for financial development. The task of economic growth and development is complex and the road to be travelled is long. Foreign financial assistance will help for the journey only if it does not substitute for some of the essential domestic ingredients.

Notes:

- \* William I. Myers Memorial Lecture, presented at Cornell University on October 4, 1989.
- \*\* Professor of Agricultural Economics and of Economics at The Ohio State University. Previously, Dean of Economic Sciences, University of Costa Rica.
- 1. See Claudio Gonzalez-Vega and Jeffrey Poyo, "Central American Financial Development," in William Ascher and Ann Hubbard, eds. Central American Recovery and Development. Task Force Report to the International Commission for Central American Recovery and Development. Durham: Duke University Press, 1989.
- 2. Neil E. Harl, "Lessons Learned from the Farm Debt Crisis of the 1980s," W. I. Myers Memorial Lecture, Ithaca: Department of Agricultural Economics, Cornell University, October, 1988.
- 3. The Report of the President's National Bipartisan Commission on Central America. New York: MacMillan Publishing Co., 1984. See also the Congressional Research Service, "Kissinger Commission Implementation: Action by the Congress Through 1986 on the Recommendations of the National Bipartisan Commission on Central America." Report No. 87-291. Washington, D.C.: U.S. Government Printing Office, 1987.
- 4. The Report of the President's National Bipartisan Commission on Central America, Alan J. Stoga, "Four Years Later: President Reagan's National Bipartisan Commission on Central America," in William Ascher and Ann Hubbard, eds. Central American Recovery and Development, cit. Another, very valuable recommendation was the scholarship program proposed by the Commission, which is contributing to an improvement of the stock of human capital in the region.
- 5. Melvyn B. Krauss, Development Without Aid. Growth, Poverty and Government. New York: McGraw-Hill, 1983.
- 6. See, for example, the influential Ragnar Nurkse, Problems of Capital Formation in Underdeveloped Countries. Oxford: Basil Blackwell, 1955.
- 7. T.E. Weisskopf, "The Impacts of Foreign Capital Inflow on Domestic Savings in Underdeveloped Countries," Journal of International Economics, II, No. 1, February, 1972, pp. 25-38, showed some of the most negative results. Gustav Papanek, "The Effect of Aid and Other Resource Transfers on Savings and Growth in Less Developed Countries," Economic Journal, LXXXII, September,

1982, pp. 934-950, showed a positive marginal propensity to save, so that only part of the aid would be offset by extra consumption.

8. J. D. Von Pischke and Dale W Adams, "Fungibility and the Design and Evaluation of Agricultural Credit Projects," American Journal of Agricultural Economics, LXII, 1980, pp. 719-726.
9. Maxwell J. Fry, Money, Interest, and Banking in Economic Development, Baltimore: The Johns Hopkins University Press, 1988, p. 49.
10. Jonathan Eaton, "Public Debt Guarantees and Private Capital Flight," The World Bank Economic Review, I, No. 3, May, 1987, pp. 377-395. John T. Cuddington, "Capital Flight: Issues, Estimates, and Explanations," Princeton Essays in International Finance, Study 58, December, 1986. Michael Dooley, "Capital Flight: A Response to Differences in Financial Risk," Washington, D. C.: International Monetary Fund Research Department, unpublished.
11. Alain Ize and Guillermo Ortiz, "Fiscal Rigidities, Public Debt, and Capital Flight," International Monetary Fund Staff Papers, XXXIV:2, June, 1987, pp. 311-332. Jeffrey D. Sachs, "Managing the LDC Debt Crisis," Brookings Papers on Economic Activity, Number 2, 1986, pp. 397-431, documents the deleterious effects of debt build-up on investment in Latin America.
12. Sebastian Edwards, Exchange Rate Misalignment in Developing Countries, Baltimore: The Johns Hopkins University Press, 1988, p. 8.
13. Manuel Ayau, Wall Street Journal.
14. Anne O. Krueger, "Aid in the Development Process," The World Bank Research Observer, I:1, January, 1986, pp. 57-78.
15. Edward S. Shaw, Financial Deepening in Economic Development, New York: Oxford University Press, 1973, and Ronald I. McKinnon, Money and Capital in Economic Development, Washington, D.C.: The Brookings Institution, 1973.
16. Chester B. Baker, "Role of Credit in the Economic Development of Small Farm Agriculture," in Small Farmer Credit. Analytical Papers, Washington, D.C.: Agency for International Development, Spring Review of Small Farmer Credit, 1973.
17. Arnoldo Camacho and Claudio Gonzalez-Vega, "Foreign Exchange Speculation, Currency Substitution, and Domestic Resource Mobilization: The Case of Costa Rica," in Michael Connolly and John McDermott, eds., The Economics of the Caribbean Basin, New York: Praeger, 1985. Claudio Gonzalez-Vega and James E. Zinser, "Regulated and Non-Regulated Financial and Foreign Exchange Markets and Income Inequality in the Dominican Republic," in Michael Connolly and Claudio Gonzalez-Vega, eds., Economic Reform and Stabilization in Latin America, New York: Praeger, 1987.



18. Claudio Gonzalez-Vega, "The Ohio State University's Approach to Rural Financial Markets: A Concepts Paper," Columbus: Economics and Sociology Occasional Paper No. 1248, Department of Agricultural Economics, The Ohio State University, February 1987. Claudio Gonzalez-Vega, "Strengthening Agricultural Banking and Credit Systems in Latin American and the Caribbean," Rome: Food and Agriculture Organization, 1986.
19. Compton Bourne and Douglas H. Graham, "Problems with Specialized Agricultural Lenders," in Dale W Adams, Douglas H. Graham and J.D. Von Pischke, eds., Undermining Rural Development with Cheap Credit, Boulder: Westview Press, 1988. The World Bank Development Report 1989. Washington, D.C.: The World Bank, 1989, summarized the problems of development financial institutions throughout the developing world.
20. Walter Schaefer-Kehnert and J.D. Von Pischke, "Agrarkreditpolitik," in Peter Von Blanckenburg, ed., Handbuch der Landwirtschaft und Ernährung in den Entwicklungslandern, Vol. I, Stuttgart: Verlag Eugen Ulmer, 1982.
21. H. Karas, "Constrained Optimal Foreign Borrowing by Developing Countries," Quarterly Journal of Economics, XLIV:3, 1984, pp. 415-440.
22. Ricardo Martin and Marcelo Selowsky, "External Shocks and the Demand for Adjustment Finance," The World Bank Economic Review, II:1, 1988, pp. 105-122.
23. David C. Colander, Neoclassical Political Economy, Cambridge: Ballinger, 1984. James Buchanan and Robert D. Tollison, eds., Theory of Public Choice, II. Ann Arbor: University of Michigan Press, 1984.
24. Pinhas Zusman, "The Incorporation and Measurement of Social Power in Economic Models," International Economic Review, XVII:2, 1976, pp. 447-462.
25. Deepak Lal, "The Political Economy of Economic Liberalization," The World Bank Economic Review, I:2, 1987, pp. 273-299. Assar Lindbeck, "Stabilization Policy in Open Economies with Endogenous Politicians," American Economic Review, May 1976, pp. 1-19.
26. Claudio Gonzalez-Vega, "Debt, Stabilization, and Liberalization in Costa Rica: Political Economy Responses to a Fiscal Crisis," in Philip L. Brock, Michael B. Connolly, and Claudio Gonzalez-Vega, eds., Latin American Debt and Adjustment, New York: Praeger, 1989.
27. Neil E. Harl, Op. cit.
28. Claudio Gonzalez-Vega, "Fear of Adjusting: The Social Costs of Economic Policies in Costa Rica in the 1970s," in Donald E. Schulz and Douglas H. Graham, eds., Revolution and Counterrevolution in Central America and the Caribbean, Boulder: Westview Press, 1984.

### References

- Baker, Chester B., "Role of Credit in the Economic Development of Small Farm Agriculture," in Small Farmer Credit, Analytical Papers, Washington, D.C.: Agency for International Development, Spring Review of Small Farmer Credit, 1973.
- Bourne, Compton and Douglas H. Graham, "Problems with Specialized Agricultural Lenders," in Dale W Adams, Douglas H. Graham, and J.D. Von Pischke, eds., Undermining Rural Development with Cheap Credit, Boulder: Westview Press, 1988.
- Buchanan, James, and Robert D. Tollison, eds., Theory of Public Choice, II. Ann Arbor: University of Michigan Press, 1984.
- Camacho, Arnolando, and Claudio Gonzalez-Vega, "Foreign Exchange Speculation, Currency Substitution, and Domestic Resource Mobilization: The Case of Costa Rica," in Michael Connolly and John McDermott, eds., The Economics of the Caribbean Basin, New York: Praeger, 1985.
- Colander, David C., Neoclassical Political Economy, Cambridge: Ballinger, 1984.
- Congressional Research Service, "Kissinger Commission Implementation: Action by the Congress Through 1986 on the Recommendations of the National Bipartisan Commission on Central America. Report No. 87-291. Washington, D.C.: U.S. Government Printing Office, 1987.
- Cuddington, John T., "Capital Flight: Issues, Estimates, and Explanations," Princeton Essays in International Finance, Study 58, December, 1986.
- Dooley, Michael, "Capital Flight: A Response to Differences in Financial Risk," Washington, D. C.: International Monetary Fund Research Department, unpublished.
- Eaton, Jonathan, "Public Debt Guarantees and Private Capital Flight," The World Bank Economic Review, I, No. 3, May, 1987, pp. 377-395.
- Edwards, Sebastian, Exchange Rate Misalignment in Developing Countries, Baltimore: The Johns Hopkins University Press, 1988.
- Fry, Maxwell J., Money, Interest, and Banking in Economic Development, Baltimore: The Johns Hopkins University Press, 1988, p. 49.

- Gonzalez-Vega, Claudio, "Debt, Stabilization, and Liberalization in Costa Rica: Political Economy Responses to a Fiscal Crisis," in Philip L. Brock, Michael B. Connolly, and Claudio Gonzalez-Vega, eds., Latin American Debt and Adjustment, New York: Praeger, 1989.
- Gonzalez-Vega, Claudio, "Fear of Adjusting: The Social Costs of Economic Policies in Costa Rica in the 1970s," in Donald E. Schulz and Douglas H. Graham, eds., Revolution and Counterrevolution in Central America and the Caribbean, Boulder: Westview Press, 1984.
- Gonzalez-Vega, Claudio, "Strengthening Agricultural Banking and Credit systems in Latin American and the Caribbean," Rome: Food and Agriculture Organization, 1986.
- Gonzalez-Vega, Claudio, "The Ohio State University's Approach to Rural Financial Markets: A Concepts Paper," Columbus: Economics and Sociology Occasional Paper No. 1248, Department of Agricultural Economics, The Ohio State University, February, 1987.
- Gonzalez-Vega, Claudio, and Jeffrey Poyo, "Central American Financial Development," in William Ascher and Ann Hubbard, eds. Central American Recovery and Development. Task Force Report to the International Commission for Central American Recovery and Development. Durham: Duke University Press, 1989.
- Gonzalez-Vega, Claudio, and James E. Zinser, "Regulated and Non-Regulated Financial and Foreign Exchange Markets and Income Inequality in the Dominican Republic," in Micael Connolly and Claudio Gonzalez-Vega, eds., Economic Reform and Stabilization in Latin America, New York: Praeger, 1987.
- Harl, Neil, E., "Lessons Learned from the Farm Debt Crisis of the 1980s," W. I. Myers Memorial Lecture, Ithaca: Department of Agricultural Economics, Cornell University, October, 1988.
- Ize, Alain, and Guillermo Ortiz, "Fiscal Rigidities, Public Debt, and Capital Flight," International Monetary Fund Staff Papers, XXXIV:2, June, 1987, pp. 311-332.
- Karas, H., "Constrained Optimal Foreign Borrowing by Developing Countries," Quarterly Journal of Economics, XLIV:3, 1984, pp. 415-449.
- Krauss, Melvyn B., Development without Aid. Growth, Poverty and Government. New York: McGraw-Hill, 1983.
- Krueger, Anne O., "Aid in the Development Process," The World Bank Research Observer, I:1, January, 1986, pp. 57-78.
- Lal, Deepak, "The Political Economy of Economic Liberalization," The World Bank Economic Review, I:2, 1987, pp. 273-299.

- Lindbeck, Assar, "Stabilization Policy in Open Economies with Endogenous Politicians," American Economic Review, May 1976, pp. 1-19.
- Martin, Ricardo, and Marcelo Selowsky, "External Shocks and the Demand for Adjustment Finance," The World Bank Economic Review, II:1, 1988, pp. 105-122.
- McKinnon, Ronald I., Money and Capital in Economic Development, Washington, D.C.: The Brookings Institution, 1973.
- Nurkse, Ragnar, Problems of Capital Formation in Underdeveloped Countries. Oxford: Basil Blackwell, 1955.
- Papanek, Gustav, "The Effect of Aid and Other Resource Transfers on Savings and Growth in Less Developed Countries," Economic Journal, LXXXII, September, 1982, pp. 934-950.
- Sachs, Jeffrey D., "Managing the LDC Debt Crisis," Brookings Papers on Economic Activity, Number 2, 1986, pp. 397-431.
- Shaw, Edward S., Financial Deepening in Economic Development, New York: Oxford University Press, 1973.
- Stoga, Alan J., "Four Years Later: President Reagan's National Bipartisan Commission on Central America," in William Ascher and Ann Hubbard, eds. Central American Recovery and Development, cit.
- The Report of the President's National Bipartisan Commission on Central America. New York: MacMillan Publishing Co., 1984.
- The World Bank Development Report 1989. Washington, D.C.: The World Bank, 1989.
- Von Pischke, J. D. and Dale W Adams, "Fungibility and the Design and Evaluation of Agricultural Credit Projects," American Journal of Agricultural Economics, LXII, 1980, pp. 719-726.
- Weisskopf, T. E., "The Impacts of Foreign Capital Inflow on Domestic Savings in Underdeveloped Countries," Journal of International Economics, II, No. 1, February, 1972, pp. 25-38.
- Zusman, Pinhas, "The Incorporation and Measurement of Social Power in Economic Models," International Economic Review, XVII:2, 1976, pp. 447-462.

Other Agricultural Economics Research Publications

No. 89-12	Dairy Farm Management Business Summary, New York 1988	Stuart F. Smith Wayne A. Knoblauch Linda D. Putnam
No. 89-13	Economic Losses to New York's Dairy Sector Due to Mastitis	Heiko Frick William Lesser
No. 89-14	Bovine Somatotrapin: Its Impact on the Spatial Distribution of the U.S. Dairy Industry	Jork Sellschopp Robert J. Kalter
No. 89-15	Strategic Alternatives For the New York Apple Industry	Bruce Anderson
No. 89-16	Farming Alternatives: Experience in New York State	Lynn H. Miller Wayne A. Knoblauch Judy J. Green John R. Brake
No. 89-17	A Guide to Using the General Algebraic Modelling System (GAMS) for Applications in Agricultural Economics	Robert W. Jefferson Richard N. Boisvert
No. 89-18	An Analysis of the Investment Related Characteristics of New York Farmers	Eddy L. LaDue Joseph H. Kwiatkowski
No. 89-19	Manufacturing Costs in Ten Butter/Powder Processing Plants	Mark W. Stephenson Andrew N. Novakovic
No. 89-20	Wages and Benefits of Full-Time Non Family Employees on Larger Than Average New York Dairy Farms	Thomas Maloney Sue Woodruff
No. 89-21	Chapter 12 Farm Bankruptcy in New York State	Raymond J. Barnes John R. Brake
No. 89-22	The Economic Implications of the U.S. Generic Dairy Advertising Program: An Industry Model Approach	Donald J. Liu Harry M. Kaiser Olan D. Forker Timothy D. Mount
No. 89-23	Operating Results for Dairy Farms Classified by Size, FCRS Data, United States, 1987	B. Stanton D. Bertelsen