# THE IMPOVERISHING EFFECTS OF FOREIGN AID

*Manuel F. Ayau*

## Introduction

The way the current debt crisis of some countries is frequently being analyzed is reminiscent of prior occasions when the solution was considered to be subsidized bail-outs of debtor nations by the governments of lending nations or by international financial agencies. These attempted solutions, however, have in most cases aggravated the problem. And those debtor nations that have achieved some economic success have achieved it in spite of, not because of, foreign aid.

In his book, *Will Dollars Save the World?* (1947, p. 29), Henry Hazlitt recalled the doubts that John Maynard Keynes raised about U.S. lending to Europe in 1919:

> "The chief objections to all the varieties of this species of project are, I suppose, the following. The United States is disinclined to entangle herself further (after recent experiences) in the affairs of Europe. . . . There is no guarantee that Europe will put financial assistance to proper use, or that she will not squander it and be in just as bad a case two or three years hence as she is now. . . . In short, America would have postponed her own capital development and raised her own cost of living in order that Europe might continue for another year or two the practices, the policy, and the men of the past nine months. . . .
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> ". . . If I had the influence at the United States Treasury, I would not lend a penny to a single one of the present Governments of Europe."[1]

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[1]Quoted from Keynes (1920, pp. 283–84). Even though Keynes had reservations about foreign aid to Europe, he did not oppose such aid. However, he would attach strict conditions to the loans, which would have to be "repaid in full" (Keynes 1920, pp. 286–87; and see Hazlitt 1947, p. 30).

"These are not the words of some American 'isolationist' in 1947," said Hazlitt, "They are words of the most influential British economist of the last generation." Hazlitt (p. 30) went on to argue that they applied with equal force to the conditions in 1947. In this regard, it is useful to recall that in Germany it was not until liberalizing and free-market policies were implemented in 1948 that economic progress was initiated.

In spite of the repeated failure of U.S. foreign aid in the past 25 years, the attempt to throw money at international problems is pervasive. Perhaps if we had a clearer understanding of the roots of the problems confronting those less developed countries (LDCs) that are most affected by the current debt crisis, we could approach a more rational solution.

## Roots of the Debt Crisis

Most analyses of the debt problem have focused on the best method of financing the debt payments. This is a real problem, but it does not go to the heart of the issue: the inefficient productive structure of the debtor-problem countries (DPCs). In order to solve the problems of the key debtor nations, we must understand the cause of their inefficient structure of production.

It is abundantly clear to me that the crux of the problem of inefficient production is a problem of education—not a problem of illiteracy, but a case of the total failure of education at the highest level to convey an understanding of basic economic concepts. I am not necessarily referring to knowledge of economics on the part of holders of degrees in economics. I am referring mainly to intelligent, articulate policy makers, most of whom have a college education. I came to this conclusion when in my quest for answers to the problems of poverty and underdevelopment, for every sensible explanation, I would encounter hundreds of unsatisfactory, contradicatory rationalizations and myths.

My first inclination, in looking for the source of poverty, was to look for evil people who were intent on making us poor. I have since forsaken this inclination. The problem is much more serious: We are kept poor by well-intentioned people who are largely ignorant of sound economic logic and who operate in a nonmarket environment. For example, with very few exceptions, government officials entrusted with designing policy in DPCs deny that there is a connection between the exchange rate and the level of employment, or that overvaluing or undervaluing foreign exchange perpetuates production patterns that are inconsistent with a country's comparative advantage.

The world educational system is very much derelict in not providing our youth with a clear understanding of the mechanisms that coordinate peoples' endeavors in society. In my studies in three different countries, I was never exposed to explanations of the constraints of the marketplace, of the price system as a system of communication, and of how under voluntary exchange one man's gain is not another's loss. This ignorance, which I shared, is the reason why the market is discarded as chaotic and unjust, and why government-planned economic solutions are invariably adopted. This educational abyss is, in the end, the cause of the debt problem.

## Analyzing the Debt Problem

*Views in Creditor Countries*

On reading the work of Weintraub (1983), Cline (1983), Roberts (1983b), and others, as well as examining some of the isolated data, I have come to the conclusion that the current debt problem, serious as it is, is not catastrophic and definitely not something that could not be readily cured by sound policies in most of the debtor countries. But this conclusion hinges on the assumption that the debtors will not be prevented from making the necessary adjustments by official bail-outs. If no subsidized bail-outs were forthcoming, some creditor banks would have to write down part of their assets. This would no doubt have some adverse economic consequences, but certainly not the dire consequences suggested by Treasury Secretary Donald Regan (1983) during his testimony in favor of the IMF quota increase last May before the Senate Appropriations Committee.

When the solution to the debt problem is discussed in the creditor nations, much faith is put in the trickle-down theory. As the recession in industrialized countries recedes, the prices of the commodities exported by the debtors will increase. As interest rates decrease in the industrialized countries, the debtors' capacity to service the debt will increase. As inflation goes on in the developed countries, the real debt will decrease.

Feelings are mixed about the effects on the DPCs caused by a change in the price of oil. For example, if the price of oil rises it will mean a boom for Mexico and Venezuela and other oil net exporters, but a tragedy for Costa Rica, El Salvador, Bolivia, Chile, Brazil, and most of the other countries who are net importers. Incredibly, a worldwide rise in the price of oil, which only a few years ago was considered a tragic event for the world, today is looked upon benignly by creditors of oil exporting countries, solely because it helps solve the problems of a few banks, regardless of the detrimental effect on the quality of life even in their own countries.

I do not mean to underestimate the effects of changes in the economies of the creditor nations on their debtors. An increase of $1.00 in the price of oil adds $250 million to Brazil's annual oil bill, and an increase of 1 percentage point in the interest rate on Brazil's external debt adds about $600 million to her indebtedness. My point is that exogenous forces, such as oil-price shocks and high interest rates, were not the main cause of the problems currently facing the DPCs; they were only a contributing factor. Focusing on them at best only delays a solution, and very likely will aggravate the problem.

It is true that a minority of people in creditor nations have identified the true cause of the problem: the economic policies of the DPCs. Unfortunately, this minority so far has been ineffectual. It is also true that many of these impoverishing economic policies have been induced or made possible by the creditor countries themselves. The uneconomical and overwhelming proliferation of state-owned enterprises in the DPCs, for example, could not have occurred in the absence of aid from creditor governments or international agencies.

In his remarks before the Senate Appropriations Committee, Treasury Secretary Regan (1983, p. 8) identified some of the economic policies that have impoverished the DPCs: "rigid exchange rates; subsidies and protectionism; distorted prices; inefficient state enterprises; uncontrolled government expenditures and large fiscal deficits; excessive and inflationary money growth; and interest rate controls which discourage private savings and distort investment patterns." The reality of the situation, however, is that the secretary's remarks appear to have been made in passing; for as Paul Craig Roberts (1983a, 1983b) has pointed out, the internationalization of the bail-outs enfeebles any attempt to influence the economic policies of DPCs. Even worse, it invariably puts the solutions in the hands of those who recommended the impoverishing policies that caused the problem in the first place.

Thus, even though sound analyses and criticisms are sometimes heard in the creditor nations, the views that prevail in the circles of ultimate decision making are not a cause of optimism for those of us in the poor countries who believe that only through a free-market economic organization can we produce the necessary wealth to pay our debts, while simultaneously raising our quality of life.

*Views in Debtor Countries*

In the debtor nations the discussion of solutions to the debt problem offers less cause for optimism. The German news service DPA reported in *La Hora,* on 15 November 1983, that at the meeting of the Federation of Latin American Banks (FELABAN) in Bogotá, Colombia, which included delegates from 16 countries and 600 banks, the most important Latin American bankers warned that applying extreme austerity measures to service the region's exorbitant debt would cause desperation, revolt, and catastrophe. The usual rationalizations, attributing the unfortunate circumstances to Uncle Sam—a popular whipping boy—and to the world in general were included in the news report. The report also contained all the usual remarks about oil price increases, deterioration of the terms of trade, high interest rates, and the world recession as the culprits. There was little reference, however, to the failures of the domestic policies of the debtor countries, which have made our economies so vulnerable, so inefficient, so inflexible, and so wasteful.

The final declaration of the FELABAN was an essentially empty and naive statement, abundant with deterministic lamentations—a symptom of the gravity of the problem. The signatories recognized that the debt, as it is now structured, is unpayable, and that the past year's experience shows that the possibility of payment is becoming even more remote. Of course, they recognized that debt servicing must be adjusted to the debtor's ability to generate foreign exchange. They also expressed the hope that exports will increase, and suggested that imports be restricted to essentials. But the FELABAN signatories offered not one word about the internal policies required to achieve those aspirations; they only mentioned that the creditor nations should lower import barriers.

The attitude throughout the FELABAN document is that the burden of the solution lies with the creditors: they must be flexible, softer, fairer, patient. One gets the feeling that our DPCs are victims of too much credit and of unfortunate acts of God, of impersonal forces beyond anyone's control, totally oblivious to the fact that our problems are the predictable results of our own prevailing economic policies. For instance, the document stated that all currencies "*suffered* devaluations or are subject to them," so debtors now face "disproportionate and unexpected burdens." This reminds me of the childish expression "the glass, it broke." The authors of the document apparently had cause and effect inverted when they referred to ". . . massive devaluation and consequent inflation."

The FELABAN's imaginative solution to the debt problems of the DPCs was renegotiations and more credits to keep the debtors alive in the hope that someday, somehow, they will repay their debts. The naiveté goes to the length of suggesting that an attempt be made to convert external debts into equity capital. This suggestion, however, is ludicrous, considering that most of the debts belong to uneconomical state-owned enterprises (SOEs). The typical attitude of less developed countries (LDCs) toward industrialized countries is expressed in the FELABAN's demands that the latter increase their subsidies to the IMF. The bankers even suggested that pressure by the IMF be applied on the creditor nations to avoid "inequalities" in the disbursement of pressure on the DPCs. Finally, there is a bit of blackmail in the FELABAN statement, announcing dire geopolitical consequences if a bail-out is not forthcoming soon. Nowhere in the statement do the Latin American bankers mention the impoverishing domestic economic policies or offer any suggestions for real reform. Most discouraging is the fact that the FELABAN declaration is not intended to be a political (demagogic) statement, but is truly meant to be a serious document.

Much of the FELABAN rhetoric reappeared in a Plan of Action (PLAN DE ACCION) adopted by Sistema Economico Latinoamericano (SELAM) at its January 9–13, 1984, meeting in Quito, Ecuador. Representatives from all Latin American countries attended the meeting, and the Plan of Action was signed by five chiefs of state, three vice presidents, and members of the cabinets of all countries attending. SELAM's secretary, Mr. Sebastian Alegrett, had stated earlier that under the present conditions, Latin America can neither pay its foreign debt nor demand more sacrifices of its people.[2]

SELAM's Plan of Action declared that responsibility for indebtedness must be shared by the creditor nations, who must reduce the cost of servicing the debt, stretch out payments, provide more resources to ensure development in the DPCs, and eliminate trade restrictions. The SELAM document included vague proposals recommending more and better clearing houses, emancipation from the dollar, more studies, more meetings, and more international, regional, and subregional institutions.

SELAM apparently ignored the fact that Latin America is already well-supplied with cadres of intergovernmental institutions, such as SELA, CEMLA, CEPAL, UNCTAD, PNUD, ALADI, SIELA (Energy), IDB, and BCI, which are the principal advocates of interventionism, regulation, uneconomic diversion of trade through highly protected common markets and trade agreements, SOEs, and all the policies that have brought about our predicament. This is a typical example of how official institutions invariably propose to correct the failures of intervention with more of the same. The failures of the SOEs for instance, did not inhibit SELAM from suggesting multi-

[2]UPI *news service report*, 15 November 1983.

national SOEs: A Latin American multinational for the fertilizer industry (MULTIFER, S.A.), the fishing industry (OLDEPESCA), energy cooperation (PLACE), and a tanker fleet. Again, nothing was included in SELAM's final resolution (PLAN DE ACCION) on internal policies; neither was there a suggestion to allow more freedom to the citizens of Latin America so that they may solve their own problems.

It is ironic that the utter failure of our interventionist economies are typically blamed on the market, on capitalism. The fact is that after the economic rule of "free enterpriser" Mr. Martínez de Hoz, Argentina was about as free-market as Yugoslavia, according to Larry A. Sjaastad (1983, p. 1129). The fact is that in Chile, as Daniel Wisecarver (1983, p. 98) tells us, "state enterprises satisfied 20% of total demand in the economy in 1981 . . ." and the capital of the twelve most important companies of CORFO [a state-owned holding company] amounted to 60% of all enterprises registered in the stock exchange. The fact is that three basic resources in the Chilean experiment—the labor market, the credit market, and the foreign exchange market—were not free. Nevertheless, all of these facts do not alter the perception that it was the market economy that failed.

The high tariffs in Latin America, the overregulation, economic controls, and so on do not seem to affect the perception that "capitalism" is the cause of our problems, and that to solve them, we must intervene further and receive more aid. Our systems are not even identified as "state capitalism." We do not allow the market to work, but blame it for our failures, while the black markets and the underground economies (the very hampered free markets) keep our economies from total collapse.

## The Opportunity for Reform

I see the present situation as an opportunity to correct this lack of understanding, to allow circumstances to force the reconsideration of alternatives, and to revise the diagnosis of the causes of the problem. The climate is propitious, but alas, I am convinced that an official bail-out will again abort any meaningful reform.

The nature of the discussion must change before a sound solution can be brought about. The following two points must be stressed over and over again. First, we (I speak for Latin America) are a continent wealthy in land, climate, and natural resources. Paradoxically, the wealthiest countries (Mexico, Venezuela, Brazil, Argentina) are the ones with the biggest problems. Obviously it is we who are doing something wrong, and not a case where something wrong is being done to us from outside. Second, the turnover of government leadership is notorious. It is not credible that we have simply been unlucky and have been damned by a succession of rascals: The system is at fault.

*Removing Barriers to Free Trade*

The prevailing notion that the market does not work so we must practice interventionism is belied by the fact that our countries are staying alive because of black markets and the underground economy. The slogan that "the free market works in theory, but not in practice" is therefore also disproved: The market does work in practice, but not in *official* theory. We must learn that in order to generate foreign exchange, we must decontrol foreign exchange transactions and lower import and export duties.[3] Debtor countries must be questioned on their practice of deliberately subsidizing the spenders of foreign exchange at the expense of the earners of foreign exchange, by underpricing the dollars their governments forcibly buy and sell. The uneconomic diversion of all resources caused by this perverse practice alone guarantees the impoverishment of any country, no matter how richly endowed.

In my country (Guatemala), the ridiculous case of free travel exemplifies the counterproductiveness of an overvalued currency. Thousands of people who never dreamed of visiting their many relatives who emigrated to the United States, now do so at no cost to themselves. They first purchase, at the official rate, the allotted amount of dollars with borrowed local currency, which they pay back immediately after selling on the black market part of the dollars they had purchased. What they do not sell is sufficient to buy a plane ticket and still have some spending money left over for their trip. This also allows people who have a second home in the United States to bring along a servant or two to cook and wash the dishes free, perhaps even making a few dollars in the process. The planes are full. More, since the quota system does not permit you to take the same servant with you more than once a year and make money out of the trip, many other servants are getting the opportunity to visit the United States, courtesy of the Guatemalan Central Bank.

Besides the high export taxes paid by the producers of foreign exchange, the subsidization of imports paid by exporters is the largest single factor burdening and depressing our agricultural export sector.

[3]It is not generally recognized that an import duty is a tax that lowers the yield to exporting activities. It is a tax on the production of foreign exchange, because to the degree that it restricts imports, it reduces the demand for—and thus the price of—foreign exchange.

Much more so than the much-lamented deterioration of the terms of trade. In Guatemala it was recently estimated that, considering the effects of import/export duties, the real cost of foreign exchange is 142 percent of the official rate. If the exporter were to be paid the true worth of his foreign earning in local currency, he would reap the equivalent of a 42 percent increase in his gross income. How our foreign exchange earnings would leap!

Yes, the increase in the cost of his imported inputs would reduce his increase in profit to somewhat less than 42 percent, but imported inputs are only a small fraction of the costs, especially in the labor-intensive agricultural sector typical of developing nations. Thus, freeing the foreign exchange market of governmental controls would be a sure cure for unemployment in the DPCs. It would also create jobs in the industrialized nations as they provided us with lower-priced goods for what are now protected, uneconomical, import-substitution goods.

*Freeing Private Capital*

How many of our central bankers or policy makers contemplate such a process? How many of them would be willing to admit that the vast amount of flight capital, estimated at more than $40 billion in the last two years,[4] is the effect of the low yield and poor investment prospects brought about by overregulation and hostility toward private capital and free enterprise? If our own capital flees, how can we expect to attract foreign investment? Finally, how many policy makers really are aware of the function of capital or know how much investment is needed to create high-productivity jobs for their country? These topics will only receive serious discussion if there are no official international financial bail-outs, so we are forced to search for other solutions to our economic problems.

Private capital is available, but we must compete for it. Recently I was visited by an investment advisor to Hong Kong capitalists. With 1997 in mind, they are looking for countries to which their capital could flee. One can anticipate that they will probably encounter a hostile climate, instigated by local lobbies of the organized industrial and financial sectors—the same groups that will applaud the new policies of channeling foreign aid through private enterprise.

International (mainly U.S.) financial aid has permitted and encouraged the statization of our economies. In general, the bigger the role of SOEs, the bigger the debt problem; because these enterprises own a large portion of the debts. SOEs were originally considered good

[4]*Impacto,* 7 January 1983.

debtors because they enjoyed the unlimited guarantee of their governments, so indirectly they have the coercive power to tax.

According to Mexican economist Luis Pazos, the Mexican government owns about 1,000 enterprises, some discotheques. Twenty-seven SOEs account for 85 percent of Mexico's foreign debt, and 58 percent of the public-sector foreign debt is owned by four enterprises: PEMEX, FERROC, CONASUPO, and CFE.

In Brazil, as of 1981, one-sixth of the country's supermarkets were state-owned. For each cruzeiro spent on conventional public investment, three cruzeiros were invested in Brazil's SOEs. Transfers of public funds to SOEs account for 77 percent of total public expenditures and for more than 25 percent of Brazil's Gross Domestic Product. More than 250 new SOEs were established over the past 10 years. The government is the owner of over 500 financial and industrial and commercial companies. According to Brazilian economist Paulo Ayres, these enterprises together with governmental agencies, are responsible for 70 percent of the nation's total foreign debt. Government enterprises in Brazil deal in autos, building products, footwear, and even buttons.[5]

In El Salvador, government-owned banks and finance companies held more than 40 percent of the nation's credit, but at the suggestion of the U.S. State Department the government confiscated 100 percent of the banking system. This is the type of ruinous policy that sometimes comes with aid, along, of course, with land reform, which typically destroys agricultural-production incentives.

Of course, all governments worthy of their "underdeveloped" status are in the businesses of land, ocean, and air transportation, chemicals, power, communications, and subsidized theaters for the cultured elite. But it is not only the accounting losses of the SOEs themselves that must concern us. The greatest damage arises because SOEs almost invariably produce at higher-than-competitive prices. Everyone who uses their services or products incurs higher costs, and since the activities of the SOEs encompass such vast and basic spheres, they make the whole economy less competitive.

This statization is the unavoidable result of aid programs that, throughout their history, have placed large amounts of soft credit (few strings attached, few questions asked) at the disposal of statist bureaucrats. Had this boon not been available to them, our debts would be minimal and our capacity to pay would be more than satisfactory. Enterprises would have been built with risk capital and without the coercive powers to impose the higher-than-market prices

[5]*Wall Street Journal*, 17 November 1983.

that reduce our capacity to pay. I do not hear any IMF conditions suggesting the sale of money-losing SOEs, although the World Bank's 1983 *World Development Report* does bring up the point, meekly.

## Some Concluding Recommendations

If the banks are not going to be allowed to find their own solution and adjustments, the next best suggestion is the one made by Paul Craig Roberts (1983b, p. 16): "If there really is a crisis requiring a bailout, we should do it by setting up a temporary revolving fund. Then, when the crisis is over, the donor countries could withdraw their funds for their own use." This fund would be an alternative to the U.S. contribution to the IMF, where the DPCs have political clout.

I believe the revolving fund can be an effective way to help resolve the debt crisis, but only if it is announced that the fund's resources are available under specified conditions. The most fundamental condition should be the establishment of a plan to free the DPCs' economies by discarding the interventionist policies that have prevented the people of these countries from creating the real wealth necessary for repaying the debt. The fulfillment of this condition would mean, with few exceptions, that those debtor countries that wished to qualify for loans would be granting freedom to their people and therefore would not need much help. By releasing the creative energy of the people and allowing the market to work, I would not be surprised to see growth rates of 10 percent and even more.

The many people who favor freedom in the poor countries, who feel a bit lonely, would be greatly encouraged to speak out. The political higher-ups would have to question the advice of their technical staffs and of the many inter–Latin American institutions (such as CEPAL, CEMPLA, and SELA) which have contributed so significantly to the impoverishment of our countries. Socialism and socialists are already more and more in disfavor. The climate is not as hostile towards the market as it was. There already exists many free-market-oriented people throughout Latin America. Many have come to conclude that P. T. Bauer was right all along regarding the impoverishing effects of foreign aid.[6] It is propitious to convert an impending disaster into a great opportunity. And this could well occur, provided, of course, that for humanitarian reasons official foreign financial assistance and subsidized bail-outs are brought to an end, so that the interventionists lose their financial support, and we have

[6]See, for example, Bauer (1972 and 1981).

no choice but to get down to the business of producing wealth through the market system.

Any radical change in policy has its "social cost." But we must not underestimate the resiliency of people; Latin America, especially, is constantly undergoing violent changes of one kind or another. Many policies may have to be phased out gradually, such as tariffs on exports and imports, but other policies, such as the freeing of exchange rates, must be done overnight. More important than where we are is where we are going. And there is little question that the social cost of change is much lower than the social cost of not changing.

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# LIBERALIZATION POLICIES AND THE IMPLEMENTATION QUESTION

*Sven Arndt*

Professor Ayau (1984) has written a provocative paper, to say the least. In a scant 12 pages, he tells us what he likes and makes very clear what he dislikes. He identifies the culprits who led us into the debt crisis, and he is impressively certain about what it will take to get us out. Unlike many other studies, this one addresses the longer-term issues.

## The Liberalization Argument

In his paper, Professor Ayau places the debt crisis in the context of economic development. He examines the shortcomings of development policy in the debtor-problem countries (DPCs) and traces the difficulties to interventionist policies in the DPCs. In his view, it is the activist, statist economic policies in the debt-ridden countries of Latin America that have been the stumbling block to economic progress, rather than external factors such as the oil price increase and high interest rates.

The argument that interventionist economic policies in the DPCs have restrained markets in various ways and made developing countries more vulnerable to external disturbances is certainly worthy of serious consideration. Moreover, Ayau extends it by applying it to foreign aid, where he argues that U.S. and other international aid has made possible the kinds of interventionist policies that he believes have seriously retarded development in the DPCs.

Professor Ayau sees the current debt crisis as an *opportunity* to reverse these distorting policies. In the absence of official bail-outs, the debtor nations would be forced to reevaluate their domestic

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