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A Review of
"Development Assistance and Trade:
Lessons Learned from Forty Years of Experience --
The Way It Was, the Way It Is, and
What the Difference Means"

by

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for the Winrock Colloquium

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Development Assistance and Trade:
Lessons Learned from Forty Years of Experience —
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OVERVIEW

This paper investigates the US's changed role in the world political economy, and how this change has effected the economic basis for US development asssitance to other nations. The authors present a summary of lessons learned from US experience with development assistance and trade since the end of World War II. Finally, they address the challenges and opportunities faced by development assistance planners and formulators of today's trade policies. The paper's table of contents provides an excellent summary of the authors' key points.

HIGHLIGHTS OF PAPER

Lessons Learned Since World War II

1. The US and the develping countries now occupy very different positions in the world economy than they did in the 1950s and 60's.

   — The US is no longer the sole dominant power with the ability to shape the international economic order as it wishes.

   — Developed countries, with their internal strength secure, no longer have the same common concern they once had in reaching a consensus on economic policy.

   — The influence of the developing countries on the international economy can no longer be ignored.

2. Our knowledge of economic growth and development, and the role that development assistance plays in accellerating the process, has increased significantly.

   — New knowledge may not be automatically brought to bear on the design and execution of new projects, as seems to be presumed.

   — The professional consensus is that development assistance plays an important role in accelerating the rate of economic growth and development of recipient countries. Yet there is a lack of empirical evidence to support this.

   — There are still gaps in our knowledge, e.g. concerning the impact of assistance on productivity.

   — There is a danger that our increased knowledge will lead us to inaction; that is, we know the prerequisites that accompany successful development projects, but the magnitute of the investment required to develop these prerequisites may be intimidating.

3. Economic and trade growth are positively and highly correlated but the factors that explain this high correlation are different than originally thought.

   - Concerning free trade theory, the authors quote Krugeman: "There is still a case for free trade as a good policy, and as a useful target in the practical world of politics, but in can never again be asserted as a policy that economic theory tells us is always right."

4. The welfare consequences of the increased US trade associated with the economic growth of the developing countries is unclear due to the indeterminant status of trade theory.

   — The economic gains from free trade may be more than offset by the economic losses from the non-optimal use of resources under monopolistic competition. The theoretical foundation for arguing that international trade benefits a country per se has become flawed.

5. Trade theorists, by default, conclude that a policy of free trade is superior to a policy of government intervention.

   — Until a unified and integrated set of economic theorems on free trade can be developed, we need to be careful about recommending a policy of free trade in specific situations.

Opportunity and Challenge: Managing the Integration of Domestic and International Policies

Three major conclusions can be drawn from the mixed record of success and failure of the international economic order that has prevailed since the end of World War II:

1. Much remains to be done;

2. We have learned a number of very valuable lessons from our experience;

3. There are major differences in today's international environment. For example: (i) the benefits of the international exchange of capital, technology, and of export-led economic growth have become widely recognized by national leaders (including China and the Soviet Union); (ii) more developing countries and countries with centrally planned socialist economies have become participants in the international economy; (iii) no one country, including the US, is in a position to dominate the management of the international economic order.

The major opportunity is to use the successful record to date and the lessons from our experience to promote an open international economic system based on the unrestricted exchange of capital, technology and commodities.

The major challenge is how to sustain the system in the face of the increased potential for policy conflict. (Five areas of potential conflict are succinctly stated under Item III in the paper's table of contents).

> "As policy planners and researchers our best approach is to address the potential conflicts with analysis and debate on the potential conflicts themselves. Solid analyses of who gains, and who loses, in the international transfer of resources, technnology and commodities would be a beginning."

DEVELOPMENT ASSISTANCE AND TRADE:
LESSONS LEARNED FROM FORTY YEARS OF EXPERIENCE--
THE WAY IT WAS, THE WAY IT IS, AND WHAT THE DIFFERENCE MEANS**

by
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CONTENTS

DEVELOPMENT ASSISTANCE AND TRADE: LESSONS LEARNED FROM FORTY YEARS OF EXPERIENCE-- THE WAY IT WAS, THE WAY IT IS, AND WHAT THE DIFFERENCE MEANS

Lon Cesal and Ed Rossmiller

, 1

DEVELOPMENT ASSISTANCE AND TRADE: LESSONS LEARNED FROM FORTY YEARS OF EXPERIENCE-- THE WAY IT WAS, THE WAY IT IS, AND WHAT THE DIFFERENCE MEANS

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I. INTRODUCTION

During the past decade economic assistance to other nations has come under increasing criticism from U.S. agricultural interests. At the same time, there is growing evidence that the economic growth and development of developing countries expands export markets for U.S. agricultural products. Paralleling this apparent inconsistency is a growing trade-protectionist sentiment in the United States that coincides with strong U.S. policy support for new GATT negotiations that are designed to reduce trade barriers. How do we account for this strange behavior?

The relative economic position of the United States in the global economy in the late 1980s is very different than during the early 1950s when the GATT was young and U.S. development assistance programs were initiated. This paper investigates the changed role of the United States in the world political economy and how the economic basis for U.S. development assistance to other nations has been changed by the altered global political and economic position of the United States as the world moves into the 1990s and the next century.

Conceptually, the relationship between development assistance, economic growth, trade, and U.S. welfare is straightforward. Development assistance increases a recipient country's rate of economic growth over what it would be without development assistance; as the country grows and develops economically it increases its trade in general, and presumably vith the United States, as a part of its trade expansion, and finally; U.S. velfare is increased by its expanded trade, either directly or indirectly, vith the developing country (figure 1). Thus, logically it would seem to follov that the stronger the relationship between development assistance expenditures and enhanced U.S. velfare the stronger the support for increased development assistance and expanded trade.

Our approach is to consider first the antecedents of U.S. development assistance and trade policies. As this analysis shows, U.S. development assistance and trade policies have been heavily influenced by international political and security concerns. We then posit three conditions that when taken together relate a country's development assistance to its own velfare

1. Postulate One: Development assistance increases the rate of economic grovth and development of a recipient country over what it would be without the development assistance.

2. Postulate Two: As countries grow and develop economically, they increase the volume and commodity composition of their foreign trade, and some shar eof this expanded trade, eitehr directly or indirectly, is with the United States.

3. Postulate Three: Expanded U.S. trade increases U.S. welfare.

This analysis concludes that, whereas much has been learned about the relationships among economic growth, development assistance, and the welfare gains from trade, the theoretical foundations for arguing that international trade always benefits a country has become flawed. While ongoing theoretical developments can be expected to contribute to repairing this flawed foundation, it will undoubtedly be some time before a commonly

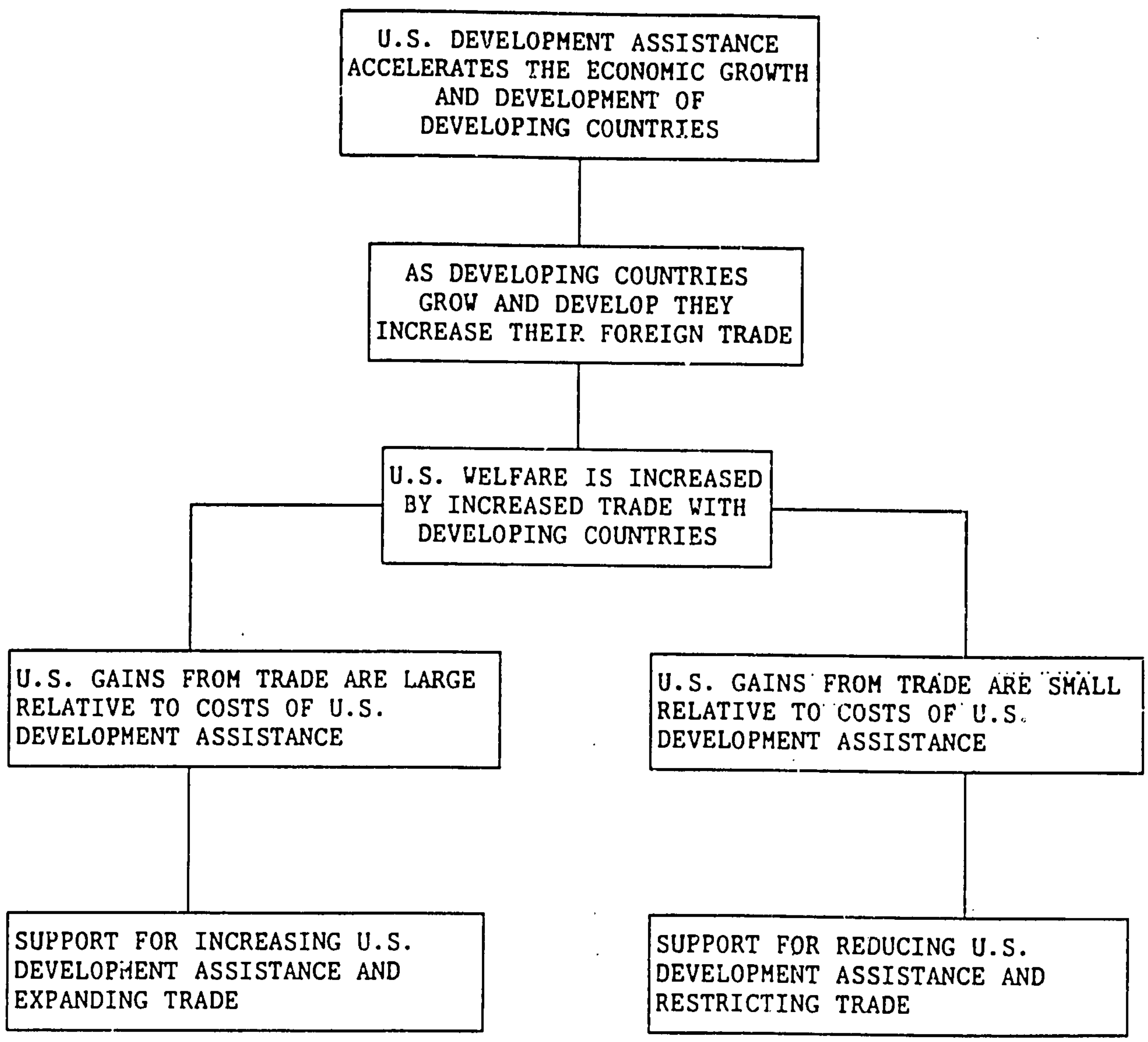

Figure 1. Conceptual Framework for Analyzing the Relationship between U.S. Development Assistance and Trade

accepted theory that explains the relationship between a country's trade growth and its welfare emerges. In the meantime, free trade as a policy has shifted from an optimum to a reasonable rule of thumb, and other supplement arguments to defend and justify an open international trading environment may have to be developed.

An abbreviated summary the lessons learned from our experience with development assistance and trade since the end of World War II is developed in Section II. Clearly, since the end of World War II the global economy has reaped enormous benefits from the strategic international economic development and liberalized trade policies of the West. At the same time, it is clear that much remains to be done--even in 1985 45 percent of the world's population receives only a little over 5 percent of the world's income.

In the final section, we address the challenges and opportunities faced by the planners of development assistance and formulators of trade policies of today. The United States no longer dominates the international economic order as it did in the first two decades following World War II. Moreover, the U.S. economy has become increasingly vulnerable to the workings of the international economy. Opportunities abound, but whether we can face up to the challenges required to take advantage of these opportunities is another matter.

II. DEVELOPMENT ASSISTANCE AND TRADE: LESSONS LEARNED FROM OUR EXPERIENCE SINCE THE END OF WORLD WAR II

1. The United States and the developing countries occupy very different positions in the world political economy in 1988 than they did in the two decades following World War II.[1]

The United States was the only global power that survived World War II undamaged. At the end of World War II the US share of world GNP was an astounding 50 percent. While the United States still has a profound influence on economic developments in the rest of the world, US GNP accounted for only about 20 percent of world income in 1983 [Sachs (64), p.1]. US exports made up nearly 20 percent of world exports in 1951-55, but accounted for only slightly over 10 percent in 1981-85 [Mackie (65), Table 7, and personal correspondence]. In the two decades following World War II the United States was the undisputed leader in providing development assistance to the developing countries. In 1986, while still the largest donor, US assistance accounted for only 26 percent of the total assistance provided by OECD and OPEC members [World Bank (67), Table 21]. Clearly, while it still occupies a position of formidable strength in the international economy, the United States is no longer the sole dominant power with the ability to shape the international economic order as it wishes.

For the West there has been a fundamental change in the political environment since the end of World War II. With the outbreak of the Cold War at the end of the 1940s, the West, concerned that its internal weakness made it vulnerable to internal Communist threats and to external pressure from the Soviet Union, tended to subordinate economic conflict. A very high priority was placed on economic cooperation, not only to rebuild Western economies, but to ensure their continued economic vitality and their political and military security. Thus, during the two decades following World War II, the developed countries had a common concern with their survival that facilitated their reaching a consensus on economic policy. Today, with their internal strength secure, and the external threat of Communisum much reduced, the developed countries no longer have the common concern they once had in reaching a consensus on economic policy. While foreign policy objectives are still important, they are not sufficient to overcome national economic interests. In the United States, and in other developed countries as well, economic interest must also be satisfied. Thus, foreign market development and national welfare have become relatively more important national objectives.

Many of the developing countries immediately following World War II were still colonies attached to Western imperial powers. By the end of the second decade following the war essentially all of these colonies had become independent states, and today a number of them have become significant participants in the international economy. In a book published in 1985, John Sewell, President of the Overseas Development Council, points out that in the 1970s the forty most advanced developing countries added more to the increment of world growth than did the United States or Japan and Germany combined [Preeg (52), p.xii]. Sewell further noted that the developing countries now account for 25 percent of world trade and are producing increasingly sophisticated products such as ships, steel, and petrochemicals. With respect to the importance of these countries to the United States, they have become major markets for the US economy and account for nearly 40 percent of US exports. Ten of the largest US trading partners in 1984 were developing countries [Preeg (52), Table B-4, p.204]. These ten countries were markets for 21 percent of US exports and provided 25 percent of US imports. GNP growth between 1965 and 1986 averaged two percentage points greater in the developing than in the developed countries [World Bank (67), Table 2.1]. Thus, while there is still a considerable gap between the level of development of the developing and the developed countries, the influence of the developing countries on the international economy can no longer be ignored. Not only has the effect of these economies on the international economy become significant, but it is likely to become more so in the future.

2. Our knowledge of economic growth and development, and the role that development assistance plays in accelerating the process, has increased significantly.[2]

In 1959 Benjamin Higgins [(22), p.xiii] in the preface of his book on economic development wrote:

> "At this point in the history of economic thought, ...the range of agreement on economic development is extremely narrow. In the case of the underdeveloped areas, economists are particularly aware of deficient knowledge. ...the pressure to discover effective means of launching economic growth is compelling economists to reconsider their concepts of the scope and method of economics. Economists are being forced into a whole galaxy of peripheral fields in which they are somewhat unsure of their footage. Not since the crash of 1929 have professional economists faced more urgent demand for answers to pressing policy questions; and not since the crash have they been so inadequately equipped to answer the questions put to them."

It was eight years later (1967) that Albert Hirschman [(23), p.188] wrote in his book:

> "Much remains to be done in understanding the conditions for success and failure of [development] projects ...".

In contrast, in 1983 after discussing a long list of lessons learned, Krueger and Ruttan [(35), p.1-13] conclude:

> "...understanding of the development process has increased. As it has increased, the effectiveness of aid efforts has increased. There can be little doubt that donor agencies (and officials in recipient governments) have a greater understanding of the development process now than their counterparts did twenty or thirty years ago."

In 1985 Cassen & Associates [(9), p.169] wrote:

> "Since so much has been said about the "learning process", the points that occur through the report will also bear repetition: that a great deal of learning has gone on. In whole ranges of [development] project types - roads, irrigation, integrated rural development, health, nutrition, education, family planning - what is done by aid today has changed radically in the light of experience."

Clearly, in the over forty years since the end of World War II we have learned a great deal about economic growth and the role of development assistance in promoting such growth. The degree to which this increased knowledge has been incorporated into US development assistance programs is not addressed directly in the literature. The presumption seems to be that new knowledge is automatically brought to bear on the design and execution of new projects. However, the validity of this presumption may deserve further consideration.

The high economic returns to some development assistance projects has lead to the general professional consensus that development assistance plays an important role in accelerating the rate of economic growth and development of recipient countries. The lack of empirical support for a strong relationship between development assistance and economic growth is attributed to the large number of other variables that affect economic development and the varied and significant time lags between the time when development assistance is given and when it affects a country's economic growth. Moreover, development assistance accounts for only about 2 percent of the capital investment available to LDC's for development purposes. There is, however, general agreement supported by theory and empirical analysis that economic growth is a function of savings and investments, and in this context, both theory and empirical analysis support the proposition that development assistance increases a country's rate of economic growth and development.

While we have learned much about economic development and foreign assistance, it would be a mistake to conclude that there are no new lessons to be learned. The gaps in our knowledge led Krueger and Ruttan [(35), p.3-15] in 1983 to say:

> "...there is a dearth of information that systematically evaluates the affect of technical assistance efforts in raising productivity in individual countries or in individual sectors across countries. ...In general evidence about how aid promotes efficiency, through technical assistance or through the introduction or spread of more productive technology, training or other mechanisms that tend to raise factor productivity, has not been systematically studied. It would appear that an important area of future inquiry on the impact of assistance should be its affect on productivity."

Numerous other examples of deficiencies in our knowledge of the development process and the use of development assistance to promote economic growth could be cited. Nevertheless, without a doubt, our knowledge of how to promote the economic growth of foreign nations through the use of foreign assistance is much greater today than immediately following the second World War.

The very substantial increase over the past 30-40 years in our knowledge of the economic growth and development process, and the role that development assistance can play in accelerating the process, has both positive and negative dimensions. On the positive side we can be more confident that appropriate development assistance activities will yield high returns. Many of the past mistakes can be avoided, and investments can be focused on the activities that have a much higher probability of succeeding. On the negative side the danger is that our increased knowledge will lead us to inaction. We now know what are the prerequisites for different types of development assistance projects. For example, improved agricultural technologies that are adapted to local conditions are a prerequisite for the development of an effective agricultural extension service. However, the magnitude of the investment required to develop the prerequisite may be intimidating. In his discussion of development projects Hirschman [(23), p.16] describes the problem as formulated by the economic historian John Sawyer:

> "...Underestimates of cost resulting from 'miscalculation or sheer ignorance' were, in a number of great and ultimately successful economic undertakings ...' crucial to getting an enterprise launched at all.' 'Had the total investment required been accurately and objectively known at the beginning, the project would not have been begun.' "

Thus, the danger is that we may be intimidated by our new knowledge of the magnitude of the prerequisites that accompany successful development projects.

In conclusion, after 35 years of experience with development assistance activities, it seems clear that by judiciously selecting development assistance projects, we can achieve higher returns to our development assistance investments than ever before. Whether we are prepared to face the challenges that this entails is another question.

3. Economic and trade growth are positively and highly correlated, but the factors that explain this high correlation are different than originally thought.[3]

United States Development Assistance during its early years was framed in a Heckscher-Ohlin world where the common view was that differences in factor endowments led to international trade. In this framework trade leads to an increase in the real income of a country's abundant factor and a decrease in the real income of a country's scarce factor. Thus, it was though that since in developed countries capital was relatively abundant, and labor was relatively scarce, trade would lead to a decrease in real income of owners of labor and an increase in the real income of owners of capital. It was commonly agreed that it would be difficult to redistribute the gains of the owners of capital to offset the losses of the owners of labor, and that for this reason labor unions in developed countries would tend to oppose free trade and favor trade protectionism. This, along with the assessment that the opportunities for inter-industry trade were quite limited, was the basis for assuming that global trade during the post World War II period would grow relatively slowly.

However, growth in world trade since World War II did not conform to expectations. Since 1950 world trade has consistently grown much more rapidly than GNP. Since 1950 the world index of manufactured exports has increased 200 percent <u>more</u> than the world index of manufactured output [World Bank (67), figure 3.3, p.43]. This discrepancy and the resulting reexamination of trade theory has left the theoretical explanation of the relationship between economic growth and trade in a state of inconclusion. Currently a number of partial theoretical explanations - increasing returns to scale, differentiated products, technology gaps, product cycles - complement the traditional Heckscher-Ohlin factor proportion theory of trade and economic growth. While all of these theoretical extensions appear to have a valid nitch in explaining a part of the relationship between economic growth and trade, no unified theory has emerged.

In conclusion, since the end of World War II our perception of the relationship between economic and trade growth has undergone dramatic change. Following the war we thought we knew more than we did. Today our knowledge is significantly greater, and we may know more than what we think. But a realistic assessment must be that the number of unanswered theoretical questions far exceeds the number of answers. Krugeman in a very recent article entitled: Is Free Trade Passé?, discusses the extent to which the unanswered questions have shaken the scared free trade foundation of trade theory:

> "...The case for free trade is currently more in doubt than at any time since the 1817 publication of Ricardo's Principles of Political Economy. This is not because of the political pressures for protection, which have triumphed in the past without shaking intellectual foundations of comparative advantage theory. Rather, it is because of the changes that have recently taken place in the theory of international trade itself. While new developments in international trade theory may not yet be familiar to the profession at large, they have been substantial and radical."

In the same article Krugeman concludes:

> "Free trade is not passé, but it is an idea that has irretrievably lost its innocence. Its status has shifted from optimum to reasonable rule of thumb. There is still a case for free trade as a good policy, and as a useful target in the practical world of politics, but it can never again be asserted as a policy that economic theory tells us is always right." [Krugeman (37), p.131-32].

4. The welfare consequences of the increased US trade associated with the economic growth of the developing countries is unclear due to the indeterminant status of trade theory.[4]

The rationale underlying this analysis is that US development assistance leads to accelerated economic growth on the part of developing nations, that the accelerated economic growth of these nations expands their trade and either directly or indirectly leads to increased US trade, and that US welfare is increased through the increased economic gains associated with its expanded trade. The theoretical and empirical evidence is that development assistance contributes to accelerating the economic growth of developing countries, and that these countries increase their trade as they grow economically. It is the relationship between expanded US trade and its affect on US welfare that is unclear. The welfare consequences in a Heckscher-Ohlin world where trade growth is driven by increased inter-industry trade are clear. Intra-industry trade accounted for over 50 percent of industrial country trade when Grubel and Lloyd (17) published their pioneering study in 1975. However, in a world where trade growth is driven by increased intra-industry trade, the welfare consequences are not clear. As Krugman [(37), p.133-34] points out, while a country may gain from free trade based on increasing returns and imperfect competition, there is no guarantee that the benefits from free trade will be realized in a second best world of imperfect competition. Helpman [(20), p.340], in his recent survey article on increasing returns, imperfect markets, and trade theory writes:

> "Apart from demonstrating the possibility of multiple equilibria, this example brings out another important feature of models with internationally increasing returns to scale; under these circumstances an economy may lose from free trade."

In other words, the economic gains from free trade may be more than offset by the economic losses from the non-optimal use of resources under monopolistic competition.

In conclusion, the theoretical foundation for arguing that international trade benefits a country _per se_ has become flawed. While ongoing theoretical development can be expected to contribute to repairing this flawed foundation, it will undoubtedly be some time before a commonly accepted theory that explains the relationship between a country's trade growth and its welfare emerges. In the meantime, other arguments to defend and justify a country's trade growth may have to be developed.

5. Trade theorists, by default, conclude that a policy of free trade is superior to a policy of government intervention.[8]

The new view of international trade, which holds that to an important degree trade is driven by economies of size rather than comparative advantage, suggests two arguments against free trade [Krugman (37), p.134]. One, an old idea that government policy should favor industries that yield positive externalities, and two, a new idea that holds that government policy can tilt the terms of oligopolistic competition to shift excess returns from foreign to domestic firms. Krugman argues [(37), p.138-39] that whereas the new trade theory, with increasing returns to size as the force that drives trade growth, has met with remarkably quick acceptance in the profession, the conclusion that this justifies a greater degree of government intervention has met with sharp criticism and opposition--not least from some of the creators of the new theory themselves. He goes on to summarize the criticism of his fellow professionals:

> "First, critics suggest that it is impossible to formulate useful interventionist policies given the empirical difficulties involved in modelling imperfect markets. Second, they argue that any gains from intervention will be dissipated by entry of rent seeking firms. Third, it is argued that general equilibrium considerations radically increase the empirical difficulty of

> formulating interventionist trade policies and make it even more unlikely that these policies will do more good than harm."

He then argues (p.141) the case for free trade as follows:

> "The well justified concern of economists is that when policies affect income distribution, the politics of policy formation come to be dominated by distribution rather than efficiency. In the case of interventions, this concern is at two levels. First, to the extent that the policies work, they will have a beggar-thy-neighbor component that can lead to retaliation and mutually harmful trade war. Second, at the domestic level an effort to pursue efficiency through intervention could be captured by special interests and turned into an inefficient redistributionist program."

To conclude, after World War II the Heckscher-Ohlin explanation of trade provided an internally consistent set of theorems that could be used to defend free trade. Today, a policy of free trade cannot be justified on the basis of such a unified and integrated set of economic theorems, and until such a theory is developed, we need to be careful about recommending a policy of free trade in specific situations.

III. OPPORTUNITY AND CHALLENGE: MANAGING THE INTEGRATION OF DOMESTIC AND INTERNATIONAL POLICIES.

It can be argued that the international economic order that has prevailed since the end of World War II has been either a significant success, or a tremendous failure. On the negative side, it is a fact that 45 percent of the world's population receive only about 5 percent of the world's income, and that in 1985 the per capita income of the low income countries was only 2.3 percent of the per capita income of the highly developed countries [World Bank (67), Appendix Tables]. Certainly, the United States has not achieved the goals of its development assistance program as they were laid out in the mid 1950s; that a:

> "...sustained program of American economic assistance aimed at helping the free underdeveloped countries to create the conditions for self sustaining growth can, in the short run, ...say in two to

> three decades, result in an overwhelming predominence of societies with a successful record of solving their problems without resort to coercion or violence. [And that] ...such a preponderance of stable, effective and democratic societies gives the best promise of a favorable settlement of the Cold War and of a peaceful, progressive world environment." [U.S. Senate (62), p.20].

Yet, there is a record of success that cannot be denied. The failures of the 1930s, when beggar-thy-neighbor policies such as high tariffs and competitive devaluations contributed to economic breakdown, domestic political instability, and international war, have not been repeated, at least not on a global scale. John P. Lewis, in a recent overview of development strategies, points out that from 1960, when many of the African countries became independent, through 1982, the gross domestic products of all the low and middle income developing countries had an average annual real growth rate (population weighted) of 4.8 percent [Lewis (40), p.24]. Moreover, if Japan's run away growth (10.4 percent a year) is excluded from the OECD average, the OECD countries grew at an annual rate of 4.1 percent, significantly less than the rate of growth of the low and middle income countries. Lewis also points out that China and India, two giants that account for two-thirds of the total population of the entire developing world, have become substantially self sufficient in food after a history of droughts, floods and food deficits. That these two countries seem to be building up a good deal of productive momentum are matters of great global significance. Finally, as noted earlier, through their increased trade a number of developing countries have become significant participants in the international economy. As a group, in 1985 the developing countries accounted for over 25 percent of world trade (excludes the trade of the Soviet Union and the Eastern European countries) [World Bank (67), Table 10].

There are three major conclusions that can be drawn from this mixed record of success and failure. First, much remains to be done. With nearly 50 percent of the world's population receiving about 5 percent of the world's income, it seems unreasonable, to paraphrase the originators of US development assistance, that we have achieved a preponderance of stable, effective and democratic societies that gives the best promise of a favorable settlement of the Cold War and of a peaceful, progressive world environment.

Second, we have learned a number of very valuable lessons from our experience since the end of World War II. To mention a few, the critical importance of appropriate domestic policies in promoting economic growth and development, the existence of essential pre-conditions for the successful execution of different types of development assistance activities, the stimulating effects of export led growth strategies on economic growth, and the importance of an open international economy based on the free flow of capital and liberalized commodity trade. Many of these lessons could only be learned from experience; there were no precedents. With the knowledge of these lessons, and especially with the knowledge that we can learn such lessons from our experience, there is good reason to be optimistic about the future.

Third, today's international environment is very different from the international environment that dominated much of the 40 year period since the end of World War II. Perhaps, the major difference is that the benefits of the international exchange of capital, technology, and of export led economic growth, have become widely recognized by national leaders. Even China and the Soviet Union have become believers. China's interest in attracting foreign investment has become well known, and at the recent World Economic Forum in Switzerland, Ivan Ivanov, the leading Soviet diplomat in charge of foreign economic relations, said that efforts were being made to cut bureaucratic red tape to accelerate the process of foreign investment in the Soviet Union through joint ventures. He indicated that 23 joint ventures had already been concluded, that 18 of those were with businesses in non-socialist countries, that some 40 others are in the process, and that there are 260 additional offers under consideration (53).

Another very significant difference between the international environment that dominated the post World War II period and the international environment that can be expected to prevail in the future is the number of significant participants in the international economy. Not only have a number of developing countries through their increased international trade, become important participants, but the centrally planned socialist economies, which isolated themselves from the international economy during much of the period following World War II, have become interested in expanding their involvement in the international economy.

Still another very significant difference between the international environment of the post World War II period and the environment that we can expect to prevail in the future is that no one country, including the United States, is in a position to dominate the management of the international economic order. This places an increased emphasis on "management by committee", and while this type of management has its strengths, it has its definite limitations.

Today's very different international environment provides both opportunity and challenge. The major opportunity is to use the successful record to date and the lessons from our experience to promote an open international economic system based on the unrestricted exchange of capital, technology and commodities. For the 25 year period 1961-85 the world economy grew at an average annual rate of 3.8 percent; 9 of the 25 years it grew at a rate of 5 percent or more, and for 14 years it grew at an average rate of 4 percent or more. During the same period the developing countries as a group grew at an average annual rate of 4.8 percent, and during 13 of the 25 years at 5 percent or more, and during 19 of the 25 years at 4 percent or more. Clearly, this is a solid record that provides a strong basis for promoting an open international economic system based on the unrestricted exchange of resources and commodities.

The major challenge of today's very different international environment is how to sustain the system in the face of the increased potential for policy conflict. The increased number of developing countries that are significant participants in the international economy, and the much more extensive linkages of developed country economies to the international economy, increases the potential for conflict in five areas. Specifically:

1. How to coordinate the domestic policies of individual countries--when such coordination requires significant domestic adjustments that benefit some countries and harm others.

A country's fiscal and monetary policies affect its interest rate and the value of its currency. Hence, under a flexible exchange rate system, the competitiveness of a country's products in international markets is affected by changes in its domestic macroeconomic policies. It follows that one country's domestic macroeconomic policies affect the relative competitiveness of another country's products in international markets and vice versa.

2. How to sustain an open international trading environment--as the vulnerability of national economies increases with their increased involvement in the international economy.

While the net gains from trade are often very significant, the absolute gain is normally diffused over many consumers, and the absolute loss concentrated on a relatively small number of producers, often in very localized geographic areas. Thus, those resisting are often much more visible than those promoting free trade as a policy.

3. How to harmonize the domestic and international policies of individual countries--when such harmonization requires significant domestic adjustments that benefit some domestic interests and harms others.

An overvalued currency benefits a country's consumers of imported goods, decreases the international competitiveness of a country's export industries, and vice versa. Thus, producers of export products view an overvalued exchange differently than consumers of imported products. Moreover, the shift to a variable exchange rate system in 1973 increased the uncertainty over how competitive a country's products are in international markets. It seems likely, also, that the variable exchange rate system has increased the instability of the international market, further excerbating the resource adjustment problems of export production.

4. How to coordinate development assistance programs and trade policy--to achieve an optimum combination of objectives related to contributions to host country economic development, US geopoltical and foreign policy interests, and enhancing US market development and trade interests such that they result in increased US welfare.

The development assistance and direct international private investment of a country affects the relative international competitiveness of the products of both the donor and recipient country. Thus, a country's products may become more or less competitive in international markets as a result of these two forms of resource transfer, and selected groups in both the donor and recipient country may gain or loose. While the absolute gains may be much greater than the absolute loses, if some of the gain is not redistributed to offset the losses of those who lose, policies that support the economic growth and development of other countries through the use of development assistance and private direct international investment may be difficult to defend.

5. How to manage the international economy, through coordination of international economic policy to create a stable global environment within which all countries can grow, prosper and gain from international economic interaction with their global neighbors.

The potential for policy conflict, and the difficulty of resolving the conflicts, has increased since the end of World War II. Net flows of official development assistance increased over 5 times, and net flows of private financial resources over 14 times between 1960 and 1982 [IMF(26), Table A.1]. In 1982 net flows of official development assistance from industrial countries to developing countries were $27.9 billion, or one-third of the total net flows of financial resources from the industrial to the developing countries. Thus, official development assistance is still important to the growth and development of the developing countries. At the same time, the increased potential for policy conflict could leave development assistance, and the free flows of resources and commodities, as scapegoats in our decreased ability to resolve the policy conflicts. As policy planners and researchers our best approach is to address the potential conflicts with analysis and debate on the potential conflicts themselves. Solid analyses of who gains, and who looses, in the international transfer of resources, technology and commodities would be a beginning.

FOOTNOTES

[1]This Section draws heavily on the work of Spero (57)

[2]I draw extensively on the Krueger and Ruttan survey of development assistance literature. It is relatively recent, thorough and it addresses a large number of the subdisciplines associated with economic growth and development assistance in a professionally objective manner. The study is extensive with 7 other professionals cited as principle contributing authors to the 15 chapters of study. Finally, their objectives were identical to mine. As they note in their introduction, the study was guided by the perspective that, if development activity is to enhance the quality of life in developing countries, it must be capable of generating the new income streams needed to enhance the individual and social consumption that contributes to the quality of life. They explain further that their objectives are to extract from the literature what could be learned about the economic impact of development assistance and to assess the factors that have contributed to success or failure of development assistance efforts as measured in economic terms.

[3]Krugman recognized Balassa (8), Grubel (17), and Kravis (7), among others, as the empirical workers who developed the original explanation of the contradictions empirical finding and received trade theory. He summarized their findings as follows: "First, much of world trade is between two countries with similar factor endowments. Second, a large part of trade is intra-industry in character - that is it consist of two way trade in similar products. Finally, much of the expansion in trade in the post war period has taken place without sizable reallocation of resources or income distribution effect."

[4].In this section I draw heavily on the material in Krugman's (37) recent article entitled "Is Free Trade Passe". Where especially relevent, I cite specific parts of the article.

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