AID, TRADE AND DEVELOPMENT: Implications of the Background Papers for the Trade Policy Working Group.

1. Introduction.

The efforts of the Trade Policy Working Group, headed by the Strategic Planning Office in AID's Policy Directorate, focused in large part on analyzing two basic issues. First, what should be AID's role in supporting US economic interests, including expanded exports and enhanced competitiveness? The key arguments here have to do with whether AID can make more of a contribution **indirectly** (pursuing development serves US economic interests, particularly export expansion) or **directly** (use foreign assistance to directly promote US exports, e.g. through capital projects, tied aid, mixed credits, etc.). Further, in the case of the direct, commercially-oriented approach, what are the implications of this approach for development impact and effectiveness?

Second, what interventions by AID in the area of trade and investment make the greatest contribution to development? Here the basic arguments revolve around the relative contribution of "framework" interventions (policy and institutional reform and improvements in the business climate) versus general promotional efforts versus support for specific transactions/deals. Further, within the realm of policy what are the relative merits of free versus managed trade?

In the course of analyzing these two issues the group produced eight working papers covering the following topics: trends in U.S. trade; determinants of U.S. competitiveness; U.S. trade policy; the impact of policy reform in developing countries on U.S. exports; capital projects, mixed credits and tied aid; Congressional perspectives on the links between aid and trade; free versus managed trade; and the development impact of promotional activities. This overview highlights the salient findings of the papers with respect to the two issues.

2. U.S. Export Performance.

Arguments in favor of using foreign assistance to support U.S. exports **directly**, and thereby improve export performance and narrow the external deficits, often are based on a premise that U.S. exports are lagging and need help, and a premise that foreign assistance can make a difference. The "trends" paper looks at U.S. trade performance, particularly exports, and the fundamental factors underlying our performance, particularly during the 1980s. The analysis indicates that neither premise holds.

First, U.S. export performance since 1986 has been exceptionally good from a variety of perspectives -- in absolute terms; compared with earlier periods; compared with other industrial countries; from the standpoint of the composition of exports; and from the standpoint of key regions in the developing world. In particular:

-- The period since 1985 has seen a boom in U.S. exports, which has substantially narrowed the U.S. trade and current account deficits. From 1985 to 1991, U.S. exports of goods and services grew at nearly 10% annually in real terms, while imports expanded by only 3.5%. The trade deficit fell from a peak of 3.5% of GNP in 1987 to 1.2% in 1991 ($160 to $66 billion dollars). The current account deficit was as large as the trade deficit in 1987, and was about $9 billion in 1991.

-- U.S. export performance **globally** has been superior to that of other industrial countries since 1986. For **each** year since 1986, U.S. merchandise exports have increased at a faster real growth rate than those of any of the other six major industrial countries. From 1986 to 1991, the **average annual** real growth rate for U.S. merchandise exports was 10%, compared with 3% for Japan and 4% for Germany. According to IMF projections this superior performance is expected to continue at least through 1993 (the last year of their projections).

-- U.S. export performance **in developing countries** has been superior to that of other industrial countries since 1986. Between 1986 and 1990 (the last year for which cross-country data were available) U.S. exports to developing countries increased by 83% in nominal terms compared with 54% for Japan and 48% for the European Community. In the critical **Asia** region, U.S. exports expanded by 113%, compared with 71% for Japan and 82% for the EC. In **Latin America**, the figures were 74%, 12%, and 44% respectively. Together, these two regions account for most of U.S. exports to developing countries. The picture is pretty much the same looking only at **manufactured** exports. For instance in Asia, U.S. manufactured exports increased by 118%, compared with increases for Japan and the EC of 71% and 81% respectively.

-- Exports of capital goods, which include sectors of concern from a competitiveness/high technology standpoint, have expanded particularly rapidly. Capital goods exports were 39% of total exports in 1991, compared with about 33% during the latter half of the 1970s, and 30% during the mid-1960s, a time when U.S. economic strength was generally unquestioned. In absolute terms capital goods exports were around $75 billion annually during the first half of the 1980s, and rose to $167 billion in 1991.

The "trends" paper also verifies the growing role of trade in the U.S. economy, and the growing role of developing countries (absolutely and relative to developed countries) as markets for U.S. exports. Between 1986 and 1991 U.S. exports to developing countries increased by 108% (from $71 billion to $148 billion), while exports to developed countries increased by 73% (from $150 to $260 billion).

3. Causes of U.S. Export Performance.

The same paper looks at **determinants** of the trends in exports and external deficits, to see whether and how foreign aid might make a difference. The findings point to no meaningful **direct** role for foreign assistance. The discussion confirms the role of **macroeconomic conditions and policies** as the essential explanatory factors, with particular emphasis on the role of exchange rates. Looking at the 1980s, U.S. export performance and external deficits deteriorated when growth in our trading partners slowed and U.S. macroeconomic policies were unfavorable; and they improved dramatically when these same factors improved. The analysis points to a potentially significant **indirect** contribution of foreign assistance to U.S. export growth, through impacts on openness and growth in developing countries. As developing countries become more open and grow, their demand for goods and services from the United States expands significantly.

The paper on **policy reform and U.S. exports** suggests that effective efforts by AID and other donors to promote openness, growth, and development can have powerful, positive impacts in terms of U.S. economic interests. This contribution, though indirect, can make a big difference in a short time. The paper examines data on U.S. export growth to countries characterized as **policy reformers**, compared with countries characterized as **non-reformers**. Over the 1985-89 period, U.S. exports increased by 77% in policy reformers, compared with about 40% in non-reformers. For Asia and Latin America, the two most important developing regions from the standpoint of U.S. exports, the increases for policy reformers were on the order of 100%, compared with about 45% for non-reformers. Extending the period under consideration to 1991, U.S. exports to the overall group of policy reformers increased by another 50 percentage points (to 126% for the 1985-91 period) while the increase in non-reformers was only 6 percentage points.

4. U.S. Competitiveness.

Several of the other papers also address the issue of direct versus indirect contributions of foreign aid to U.S. economic interests. For instance, some would argue that even if U.S. foreign aid has little role to play in terms of aggregate export and balance of payments performance, the somewhat distinct problem of **U.S. competitiveness** is one where foreign aid can make a difference. To shed light on this argument a third paper looks at

"Sources of U.S. Competitiveness". The paper goes to some length to present an acceptable definition of competitiveness, and cites the work of some of the key contributors in the area, including Michael Porter, Paul Krugman, Robert Reich, Peter Drucker and Mancur Olson. The policies important for promoting competitiveness are those which enhance productivity and technology here in the U.S., including strengthening education, support for advanced training and research, better infrastructure, etc. According to the paper, "Subsidies for exports under U.S. foreign assistance programs are likely to be at best irrelevant, and at worst counterproductive". The key markets from the standpoint of competitiveness are in developed rather than developing countries, since exports to the latter group tend not to be in the "leading edge", high technology sectors normally associated with U.S. competitiveness. Subsidies for U.S. exports to developing countries would be counterproductive insofar as they diverted U.S. industrial and technological capabilities from leading edge production to those items exported to developing countries.

5. U.S. Trade Policy.

While economic arguments and analysis along the lines outlined above clearly point towards an indirect (but significant) role for foreign aid in promoting U.S. economic interests (as opposed to using foreign aid to directly promote U.S. exports), these would be irrelevant if U.S. trade policy pointed in the opposite direction. The paper on "U.S. Trade Policy" reviews authoritative statements of our trade policy and finds them to be fully consistent with the sorts of analysis and empirical evidence discussed above. The most authoritative statements of U.S. trade policy -- those contained in the President's 1992 Trade Agenda issued by USTR, and those contained in recent annual editions of the Economic Report of the President -- affirm the Administration's basic commitment to promoting U.S. economic interests by improving the **framework** within which trade and investment take place -- the policy and institutional environment. They emphasize the Administration's opposition to "managed trade" and protectionism (i.e. government actions that attempt to influence specific market outcomes). While in practice there are and always will be some exceptions resulting from specific political pressures, at the level of trade policy there is no support for using foreign assistance either to directly support U.S. exports in general, or to support selected exports in selected markets.

To cite just two statements quoted in the paper, President Bush affirms in the transmittal letter of the Economic Report of the President 1991 that "my Administration will continue to push aggressively for open markets in all nations, including our own, and will continue to oppose protectionism...Government attempts to overrule the decisions of the international marketplace and to manage trade or investment flows inevitably reduce economic flexibility and lower living standards." U.S. Trade Rep Carla Hills, in the introduction to the President's 1992 Trade Policy Agenda, states that "[U.S.] policy is to ensure that foreign markets that **are** open **stay** open, and markets that are closed are made accessible to competitive U.S. exporters and investors. By opening markets and allowing trade to expand according to free choice, not government intervention, we can guarantee economic success, long term growth, and more and better jobs for the citizens of the United States."

These statements clearly reinforce the "indirect" or developmental approach to promoting U.S. economic interests, particularly policy reform activities that result in more open markets in developing countries. They do not support the "direct" or commercial approach.

6. Capital Projects.

Commercially motivated aid practices such as tied aid in general and mixed credits in particular are examined in a fifth paper on "The Role of Capital Projects in A.I.D. Assistance". This paper first clarifies the basic issue, which is NOT whether capital projects as such contribute to development, but instead whether capital projects (and other aid practices) designed to directly promote commercial interests do so at the expense of development effectiveness. The paper discusses arguments concerning the negative impacts of tied aid on aid effectiveness, and empirical estimates of the costs of tied aid. These latter studies indicate that the excess cost margin associated with tying aid typically ranges between 15 and 30%. A particularly troublesome form of tied aid is mixed credits (or tied-aid credits), usually associated with capital projects, in which a country mixes foreign aid with commercial trade credits to gain commercial advantage vis-a-vis firms from other countries. The paper points out that the U.S. has traditionally opposed the use of mixed credits on grounds that they tend to distort aid and trade. [Mixed credits tend to distort aid by biasing the selection of capital projects; distorting the balance between assistance for capital projects and assistance for other important development efforts; and by biasing the allocation of assistance among countries.] Throughout the 1980s the U.S. tried to limit the use of such practices by aid donors, efforts which culminated in the 1991 "Helsinki Agreement".

The paper conveys two basic messages: first that a "direct" or commercial approach to using foreign aid to promote U.S. exports is likely to pose significant tradeoffs in terms of development objectives; and second, that U.S. policy, in recognition of this, has consistently sought to limit the use of commercially motivated aid practices by other donors.

7. Foreign Assistance and Promotion of U.S. Exports.

The combined force of these arguments is that the case for using foreign assistance to **directly** promote U.S. exports is problematic on **economic** grounds (the benefits from the standpoint of the U.S. economy, particularly impacts on export growth and competitiveness are negligible); on **development** grounds (the costs of commercially motivated aid practices in terms of development effectiveness can be significant); and on **U.S. trade policy** grounds (inconsistency with both the broad thrust of U.S. trade policy and with specific U.S. efforts to influence practices of other donors). The **indirect** approach is supported by all three of these considerations.

In the end the main arguments for the direct (commercial) approach tend to be **political** -- that tying foreign aid more visibly to U.S exports will win political support for foreign aid. Yet even this argument is problematic. A sixth paper looks at "Congressional Perspectives on the Trade/Aid Linkage". It acknowledges that the combined impact of the end of the Cold War, the recession, and the election has been to make it more difficult to get Congressional support for foreign assistance. However, it notes that much of the pressure to link foreign aid more clearly to U.S commercial interests has **originated** with Members of Congress whose responsibilities are in the **trade** area rather than with members who serve on A.I.D. oversight committees. The major Congressional leaders on foreign aid have thus far ensured that development assistance has been exempted from legislative targeting for funding capital projects and for mixed credits. This reflects the beliefs of the leadership of the foreign assistance authorization and appropriations subcommittees that A.I.D. should use its development funds to focus on its development mandate. Indeed, given the current prohibition on using development assistance for tied-aid credits, and the successful efforts of the leadership of the Senate's foreign assistance oversight committees in holding development assistance "harmless" from capital projects targets and earmarks, some in Congress have questioned the Agency's judgement in offering to fund capital projects out of its development assistance funds. While supportive of efforts to strengthen U.S. exports, the leadership of the House and Senate Appropriations Subcommittees on Foreign Operations would prefer to achieve this end by increasing funding for the Ex-Im Bank, OPIC, and TDP, rather than displacing development assistance funds. Recent indications are that if it felt commercial rather than developmental issues were driving the Agency's development assistance requests, the Obey Subcommittee would consider in the future reducing A.I.D.'s budget requests and instead directly funding capital projects in the United States.

These findings suggest that even the political case for using foreign aid to directly promote U.S. exports and other commercial interests is, at best, problematic. The paper indicates that

Congressional leaders familiar with foreign aid are all too aware of the negative impacts (mentioned above) of commercially motivated aid practices on the development effectiveness of foreign aid. Indeed, efforts to gain political support for foreign aid by emphasizing commercially oriented aid practices have in some respects backfired, eroding support for foreign aid among traditional backers and raising critical questions about A.I.D.'s sense of its own role and mission.

8. Trade, Investment and Development.

Turning to the second large issue, the main question has to do with the developmental contribution of interventions to promote trade and investment. CDIE contributed a seventh paper, "Export and Investment Promotion -- Findings and Management Implications from a Recent Assessment". With consensus on the critical importance of the policy setting in determining the contribution of trade and investment to development, the paper considers whether and when it makes sense to allocate scarce foreign assistance resources to promotional activities. The paper finds that well-designed promotional activities can play an important role, but in a fairly restricted set of circumstances in which the policy setting is conducive to efficient trade and investment, but the market for support services is not yet active and well-functioning. Expressed somewhat differently, the services associated with promotional activities can in principle be effectively provided by private markets, once the policy setting is favorable. But it might take some time for these markets to come into being and develop. During this period of "infancy", donor-sponsored promotional activities can make an important contribution. But this contribution would be transitional and time-bound.

The CDIE paper does not explicitly take on the issue of direct match-making for business deals versus support for more generalized promotional activities. However the discussion of the rationale for promotional activities (get the private market for support services going in response to policy reforms) and the discussion of how best to do this (focus on a variety of private support service providers) suggest that a direct role in individual transactions will rarely be the most effective use of donor resources.

9. Managed Trade and Industrial Policies.

If the most important factor influencing the contribution of trade and investment to development is the policy and regulatory setting, what sort of setting is most effective? This question is addressed in an eighth paper, "How Should Developing Countries Promote Export Growth? Free Trade vs. Selective Intervention". While there is a strong consensus that import substitution strategies haven't worked, and that "outward-oriented" policies are superior, there is a vigorous and continuing debate as to what constitutes an effective outward-oriented policy setting. Much of the debate has focused on the experience of South Korea, which achieved exceptionally rapid growth in manufactured exports with policies that were both highly outward oriented and highly interventionist. The debate revolves around the role and importance of interventionist policies in Korea's export success.

The paper reviews some of the key articles and books in this debate and concludes that intervention probably worked for Korea (in the sense of making a positive contribution) but that Korea-style approaches are not likely to "travel well". More specifically, the paper argues that "political and administrative constraints typical of most other developing countries make the adoption of such [interventionist] policies risky at best, and potentially disastrous. For LDC policy makers to use interventionist policies productively, they have to be able to carry out two major tasks, each of which poses a daunting challenge. First, they have to identify industries with export potential, and do so more effectively than the market. In effect, they must be able to anticipate where domestic and world market conditions will be several years in advance, and do so more accurately, more reliably, and more flexibly than the thousands of domestic and foreign entrepreneurs scouting the horizon for profit opportunities...The second major challenge...is that of knowing when to **remove** special incentives from an industry, and being willing to do so." The paper concludes that A.I.D. policy advisors should refrain from advocating the adoption of export strategies relying on discretionary industrial and trade policies.

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