Trade, Foreign Investment and Development
Preliminary Draft
9/18/92

I. Introduction

This policy paper updates and supersedes the July 1986 A.I.D. "Trade Development" policy paper.

Substantial changes in the environment for world trade and the specific context within which A.I.D. operates have contributed to the need for a new policy:

-- developing countries' recognition since the late 1980s of the importance of trade liberalization to their development efforts, and the entry of the formerly state-controlled economies of Eastern Europe and the Soviet Union onto the international scene;

-- the rapidly growing importance of developing countries as an export market for the United States;

-- the increasing integration of developing countries into the mainstream of the world trading regime through their enhanced participation in the General Agreement on Tariffs and Trade (GATT) and outward-oriented regional arrangements, and the prospects of greater coverage of their major exports under GATT regulations;

-- the conclusion of an important new international agreement restricting the use of aid funds by U.S. competitors to subsidize export finance, coupled with a growing debate over whether foreign aid should directly promote U.S. commercial interests;

-- the increasing significance of trade and investment as an objective of A.I.D. programs, and the results of an important multi-year evaluation of A.I.D. trade and investment promotion projects.

As a result of these and other changes in the environment within which A.I.D. seeks to encourage trade and investment in developing countries, this policy differs from the 1986 policy in the following major ways:

-- It responds to the need for clearer priorities for intervention expressed by A.I.D. officers who now have some years of experience in this field.

-- It reflects the findings of the Agency's recently completed, comprehensive evaluation of export and investment promotion activities.

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- -- the increasing integration of developing countries into the mainstream of the world trading regime through their enhanced participation in the General Agreement on Tariffs and Trade (GATT) and outward-oriented regional arrangements, and the prospects of greater coverage of their major exports under GATT regulations;
- -- the conclusion of an important new international agreement restricting the use of aid funds by U.S. competitors to subsidize export finance, coupled with a growing debate over whether foreign aid should directly promote U.S. commercial interests;
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As a result of these and other changes in the environment within which A.I.D. seeks to encourage trade and investment in developing countries, this policy differs from the 1986 policy in the following major ways:

- -- It responds to the need for clearer priorities for intervention expressed by A.I.D. officers who now have some years of experience in this field.
- -- It reflects the findings of the Agency's recently completed, comprehensive evaluation of export and investment promotion activities.

-- It expands on the contribution of trade and investment to development, reflecting recent refinements in trade theory and incorporating the findings of the World Bank's trade-focused 1987 World Development Report.

-- It addresses head-on the question of how best to serve U.S. economic interests through judicious use of the U.S. taxpayer's foreign aid dollars.

-- It gives extensive consideration to the recently negotiated agreement on mixed credits and provides updated guidance consistent with it.

-- It upgrades the role of A.I.D. in U.S. trade policy decisions from a conduit for information to an active participant in trade policy deliberations.

This new policy also responds to a strongly felt need within the Agency for revised trade and investment guidance. An outside consultant surveyed a broad cross-section of Agency staff, all of whom stated that new guidance was required. This policy is also the product of many months of rigorous, balanced analysis and open dialogue. Eight background papers addressing specific issues were prepared by an inter-bureau Trade Policy Working Group, and no fewer than six Agency-wide meetings and many more informal discussions on the analyses and emerging conclusions have occurred. These analyses are cited in the bibliography.

This policy is intended to guide programs having trade and investment as a priority objective; it does not address the relative priority which should be assigned to trade and investment in relation to other areas of development activity. Given the breadth of coverage of trade and investment programs, however, the pattern of A.I.D. intervention outlined in this policy is expected to have broad applicability across sectors where encouraging trade and investment is considered a priority.

II. Trade, foreign direct investment and development

A. Contribution of trade to LDC economic growth

Both economic theory and the lessons of experience from successful countries support a strong connection between a country's economic growth and its openness to trade. After gaining their independence, many developing countries associated free trade and investment with colonial exploitation of primary resources, leading them to turn inward to import substitution strategies. Communist countries' limited trade took place according to bureaucratic dictates rather than the free market. In the late 1980s, however, the growing realization by most developing countries that import substitution had produced disastrous economic results, and the newfound outward orientation of the former Communist bloc, underscored the essential role of trade in building national and international prosperity.

In the early 19th century David Ricardo advanced his theory of comparative advantage which, despite the increasing complexity of the world economy, maintains broad validity today. Ricardo argued for gains from trade based on specialization and improved resource allocation, and this still holds true. However, experience has borne out as well a number of longer-term, dynamic gains arising from such factors as increased competition, economies of scale, externalities, learning by doing, and transfer of technology.

While precise causality cannot be established, there is a high correlation between openness to trade and economic growth in the experience of both developed countries and developing countries. In their developing years, today's industrial countries maintained lower tariff and nontariff barriers than do today's developing countries. More recently, economic growth and development have been highly correlated with an outward economic orientation, while unsuccessful development efforts have tended to accompany import substitution and high levels of protection. The East Asian "Tigers" have achieved once unforeseeable prosperity during the same period in which most of Africa and the rest of Asia were stagnating behind protectionist walls; more recently Chile, and now other countries in the Western Hemisphere, have shown remarkable success after opening up their economies.

However, significant impediments to trade remain in many developing countries. Some of the most significant include quantitative restrictions, high effective rates of tariff protection, import licensing, foreign exchange restrictions, poor markets for information on export markets, and protection in potential export markets. Not all, but most of these are within the scope of the individual country to address, and not dependent on the external environment. Experience has demonstrated that unilateral liberalization, even in the absence of corresponding liberalization by trading partners, provides considerable gains to the implementing country.

LDCs which have not yet succeeded in diversifying the structure of their exports away from primary commodities continue to experience fluctuating export earnings in response to price shifts and consequent instability in their trade balances. Many of these countries practiced import substitution rather than an outwardly oriented strategy and are now in a position of having to make up for lost time.

B. Trade and foreign investment

Direct foreign investment can be attracted into either highly protectionist or open environments. Where investment takes place behind protectionist walls, it can lead to inefficient production patterns; if financial returns to the investor are higher than economic gains to the economy, it may actually cause a net loss of foreign exchange. In contrast, productive foreign direct investment -- in the presence of evenly enforced investment codes, low levels of protection, and without "sweetheart deals" based on tax breaks or subsidies -- can contribute to economic growth by increasing the capital stock and promoting innovation, efficiency, and technology transfer in the host country. Foreign companies also tend to engage more in trade than do local companies.

Licensing requirements, restrictions on repatriation of profits, local content requirements, export performance requirements, inadequate property rights protection, a generally inconsistent legal and regulatory regime, and unstable macroeconomic policies are examples of some of the problems which can deter economically beneficial investments in developing countries. In the absence of changes to address such problems, countries risk discouraging DFI or attracting unproductive investments.

Before World War II, most foreign investment in LDCs was concentrated in extractive industries and plantation agriculture; in the postwar period, it has moved increasingly into manufacturing and, more recently, into services industries. Direct foreign investment in LDCs grew at a fairly steady 6% between 1970 and 1989. After climbing steadily in the 1970s it tapered off in the early eighties, but by 1988 had regained its 1981 level. There are, however, significant regional variations: over 1970-89, DFI increased 12% in real terms to Asia, 3% to Latin America, and declined to Africa. While a broader range of LDCs than in the past benefits from DFI, investment still remains highly concentrated in Asia.

C. Open markets and selective intervention

Export-oriented economic strategies are by now recognized as far more effective in promoting growth than import substitution. However, debate continues over the merits of the Korea model of selective intervention to promote exports as opposed to the more "hands-off" government strategy taken by most other successful countries and usually recommended to developing countries as the best course. It is generally accepted on both sides of the debate, however, that, all things considered, the extent of government intervention in Korea was actually fairly moderate, and that the interventions tended to follow rather than lead market signals by removing protection and allowing firms to close if they were unable to meet performance standards.

Although there is not full agreement on whether selective intervention helped or hindered Korea's growth, the preponderance of evidence indicates that government-led export and investment growth is an extremely difficult course for the average LDC to pursue. Few LDCs can boast the same combination of strong administrative capability and bureaucratic insulation from business pressures, or single-minded adherence to export growth irrespective of its impacts on individual firms. More countries have achieved economic success through liberalized trade policies and reduced government intervention.

III. Trade in the world economy

A. Trends in world trade

Worldwide trade has grown by more than 6% annually since 1950, over 50% faster than growth in global output. Since 1950, growth in world trade has consistently outstripped global GDP growth. Between 1950 and 1975, the volume of world trade increased by 500%, compared to an increase of 220% in global output; since 1975, although it has slowed somewhat, trade has continued to outstrip production. LDC exports have seen average growth of over 5% annually since 1965, with an overall relative shift toward manufactures relative to agricultural and mining. Much of this shift toward manufactures is accounted for by East Asia.

The major success of the General Agreement on Tariffs and Trade (GATT) has been the dramatic decline in industrial-country tariffs on manufactures: from over 40% in 1947 to under 5% currently. Agricultural trade, however, has remained largely untouched by the GATT and has become increasingly subject to a variety of restrictions. Also, new forms of nontariff barriers have arisen in recent years, presenting new challenges to the multilateral trading system.

The Uruguay Round of GATT negotiations is intended to expand multilateral trading rules to cover new areas such as investment and services and extend coverage in sectors of critical importance to LDCs such as agriculture and textiles, as well as addressing nontariff barriers and more general problems of market access. However, at the same time that negotiations have been taking place protectionism and politicization of trade issues, driven by a stubborn recession and difficulties of adjustment to a post-Cold War world, have been on the rise in most developed countries.

While multilateral negotiations have been under stress, there has been a resurgence of interest in regional integration on the part of both developed and developing countries. The significance of this new interest in regionalism for the world trading system is a subject of debate. Some fear that current trends toward regional trading arrangements signal a breakup of the world economy into trade-distorting blocs. However, regional arrangements are permitted under GATT rules provided that they cover substantially all trade among the participants and do not raise external barriers to third countries. The 1992 Economic Report of the President points out that "avoiding trade frictions through strengthened multilateral trade relations is...essential to assure that the formation of regional free-trade areas contributes to greater world welfare," and multilateral integration through the GATT remains the primary goal of U.S. trade policy.

B. U.S. trade philosophy and policy

Throughout the postwar period, the United States has played a leadership role in fostering free trade and global open markets. Initiating the current Uruguay Round of trade talks, the U.S. sought to expand world trading rules to include trade-related investment as well as to expand GATT coverage in areas such as services, agriculture and textiles. It also has sought to address non-tariff barriers in addition to GATT's traditional focus on tariff reduction.

The Economic Report of the President and the President's 1992 Trade Policy Agenda, in delineating U.S. trade policy priorities, both underscore the benefits of open trade. According to the 1992 ERP, "Retreating from a focus on open international markets now would undermine opportunities to promote a growing and efficient world economy." The Agenda reiterates successful conclusion of the GATT Uruguay Round, conclusion of the North American Free Trade Agreement, and the opening of foreign markets, in that order, as the Administration's key trade priorities. Some see in U.S. market-opening measures such as countervailing duties and 301 actions a trend toward increased protectionism. However, the dominant strain in Administration trade policy remains promotion of open markets and multilateral trading rules and rejection of managed trade and protectionism.

C. U.S. trade and investment trends

U.S. exports of goods and services rose steadily between 1960 and 1980, dropping back slightly in the mid-80s and then rising to 11% of GNP by the start of the 1990s. The dropoff in the mid-80s is widely attributed to the dramatic appreciation of the dollar in relation to other major currencies, combined with worldwide recession. Economic recovery, as well as the depreciation of the dollar to a more realistic exchange rate, in the latter half of the 1980s brought a boom in worldwide investment and demand for capital goods. U.S. export industries have been among the prime beneficiaries. According to the IMF's 1992 World Economic Outlook, U.S. merchandise exports have consistently outpaced those of other major industrial countries since 1986. The Department of Commerce estimates that the share of U.S. employment supported by U.S. merchandise exports increased from 5.7% in 1986 to 7.4% in 1990, as a result of rapid growth in merchandise exports and slower growth in the rest of the economy. Moreover, capital equipment as a share of U.S. merchandise exports has grown consistently: from 30% in the mid-60s, it now accounts for almost 40% of exports. High-tech jobs supported by U.S. exports grew 53% over 1983-90 compared with 37% job growth in other export-related manufacturing.

LDCs are the fastest growing market for U.S. exports. Between 1986 and 1991, U.S. exports to developing countries more than doubled, from $71 billion to about $148 billion. According to the 1992 USTR Annual Report, from 1990 to 1991 U.S. exports grew more than four times faster to developing countries (14.2%) than to other developed countries (3.4%). The U.S. has been gaining market share in each of the four main developing regions, with our exports to each of these regions increasing more rapidly between 1986 and 1990 than Japan's or the EC's.

Between 1980 and 1988, the United States provided the largest share, 31%, of direct investment in developing countries. Between 1985 and 1989, U.S. direct foreign investment increased by 62%, with LDCs accounting for a progressively greater share of the total. Latin America and the Caribbean accounted for most of the growth, although Hong Kong, Korea, and Taiwan benefited significantly from U.S. manufacturing investments.

IV. The role of A.I.D. programs in promoting trade and investment for development

A. Purpose of A.I.D. trade and investment programs

The principal purpose of A.I.D. is to promote development, which is deemed to be in the broad foreign policy and economic interest of the United States. A.I.D. accomplishes this through the use of U.S. government resources in carefully designed and executed projects and programs, intended to help achieve economic growth and social progress without disrupting well functioning markets. Accordingly, before intervening with public money directly in trade and investment markets A.I.D. must ensure that priority development objectives are being served and that market efficiency is being supported rather than undermined.

A.I.D. interventions to support trade and investment for development therefore will be designed in order to achieve specific and measurable progress on one or more of the following objectives over a specified time horizon:

-- to improve policies which have an important impact on trade and investment;

-- to achieve positive change in the business environment within which trade and investment decisions are made; or

-- to help promote a more rapid market response to policy reforms or to changes in the business environment.

This "intervention hierarchy" is consistent with the U.S. priority on supporting well functioning private markets in a clear and fair environment rather than intervening in individual business decisions. According to the the World Bank's 1991 World Development Report, "Markets fail, but so do governments. To justify intervention it is not enough to know that the market is failing; it is also necessary to be confident that the government [A.I.D.] can do better."

B. A.I.D. role in trade and investment policy reform

Assisting countries to undertake and sustain relevant policy reforms will often be the most important contribution A.I.D. can make to maximizing the role of trade and investment in a country's development. Appropriate policies create favorable conditions for the development of efficient private sector markets, and are positive not only in and of themselves, but as a basis for LDCs' enhanced participation in world trade and outward-oriented regional arrangements. Types of policy improvements likely to have the greatest impact on trade and investment include:

- Macroeconomic stability: stable fiscal and monetary policies
- Sound exchange rate policy: avoiding significant overvaluation and promoting currency convertibility
- Trade policy: replacing quantitative trade restrictions with tariffs, lowering tariffs and making them more uniform (may require selective duty-drawback schemes in the short run)
- Market pricing: appropriately priced financing, market-determined wages, removal of subsidies

- Tax policy: removing onerous direct taxes or penalties on exporters or investors, or reforming the tax system to account for lost tariff revenue

Experience has shown that successful and sustainable reform requires careful attention to the interactions among different policy changes. Trade policy liberalization in the past has generally failed in the absence of exchange rate and macroeconomic stability. Comprehensive and decisive reform has also been generally more successful than piecemeal, stop-start reform. Appropriate involvement of the business community and other concerned stakeholders in selection and implementation of reforms also has an important impact on sustainability.

A.I.D. is well placed to facilitate such reform because of its ongoing field presence and experience with policy reform, and its leadership in this area is acknowledged by other donors. Missions should use their experience and judgment about specific country circumstances in selecting the most appropriate and effective mechanism to achieve policy reform (e.g. Commodity Import Programs, cash transfers, project intervention, food aid). Whatever type of intervention is chosen must show real prospects of achieving measurable progress on sustainable policy reforms over a specified time horizon.

C. Fostering change in the business environment

A.I.D. can also make an important contribution to institutional changes that clarify and strengthen the business environment in which trade and foreign investment decisions are made. Even where policies in the areas mentioned above are generally favorable to trade and investment, the institutional framework ("rules of the game") may continue to present obstacles to trade and investment. Where significant progress toward favorable policies has already taken place and is being sustained, A.I.D. assistance in this area can help further systemic change to foster sustainable trade and investment. Types of changes in the business environment likely to have a significant impact on trade and foreign investment include:

- <u>Laws</u>. Secure property rights; dispute settlement procedures; clear and secure contract rights; clear and non-discriminatory tax and commercial codes

- <u>Regulations</u>. Lifting of onerous export or investment licensing requirements and other barriers to entry; removal of export requirements and local content rules; establishment of internationally consistent norms and standards; design of appropriate regulatory systems

- "Red tape." More efficient and effective customs procedures; streamlined implementation (paperwork, etc.) of existing laws and regulations

As with policy reform, A.I.D. intervention to improve the business environment must show real prospects of effecting meaningful and sustainable change in the business environment over a short time horizon.

D. Export and investment promotion

A.I.D. can sometimes help promote a more rapid market response to reforms already enacted. Even where correct policies are in place and the business environment is generally favorable, the market response in terms of increased trade and investment may be slow due to weaknesses in markets for support services that provide information about available markets, contacts, or specific guidance on how to adapt production to the market. In such cases, there may be a rationale for transitional A.I.D. assistance with trade and investment promotion services to promote a more rapid market response. However, before providing assistance for this purpose it must be shown that the overall environment is favorable, that the private sector market for such services is not yet functioning adequately, and that nontraditional exports have therefore not yet taken off.

Exporters and investors rely most heavily for many informational and technical services on buyers, foreign partners, suppliers and other contacts, rather than on government or private promotional institutions. However, in initial decision-making stages would-be exporters or investors are likely to depend more on such promotional services: potential exporters highly value foreign market information and buyer contacts; potential investors, country- and sector-specific information. In assisting with promotional services, therefore, missions should generally emphasize services to new exporters or investors which are likely to lead to long-term linkages with commercial service providers, and avoid providing technical assistance for production directly.

Experience teaches a number of lessons with respect to service providers:

-- No single service provider can meet the diverse needs of exporters and investors. Standardized services and customized services often require different institutional structures. Therefore, assistance should normally not be limited to a single service provider.

-- Government agencies have rarely met four key conditions for successful export promotion: business community support, adequate funding, commercially competitive salaries, and autonomy from the government. Similarly, government investment promotion agencies have generally become excessively concerned with regulation rather than promotion of investments. Therefore, in providing assistance for trade and investment promotion A.I.D. missions should avoid government agencies, concentrating instead on private membership or not-for-profit entities for export promotion and quasi-governmental or not-for-profit private organizations for investment promotion.

-- Despite initial expectations, fee income generally cannot be expected to ensure the financial sustainability of promotional institutions. Therefore, although the charging of fees should continue to be part of A.I.D.'s design of promotion programs, financial sustainability of the institution through fee income should not be a criterion for assistance.

Economic analysis of promotion projects normally should go beyond traditional examination of employment and export impacts, to include analysis of growth of the private support services market and the growth of nontraditional exports. Impact is likely to be greatest in hitherto underexploited sectors on the "investment frontier," but visible impact at the national level should not normally be expected from a promotional program.

E. Facilitating business transactions

Trade and investment are central to economic growth and development, and individual business transactions are the fundamental building blocks of healthy, well functioning markets for trade and investment. As a development agency, A.I.D. seeks through its trade and investment programs to maximize economically productive business transactions in developing countries. The question is how best to do this, given limited foreign aid funds and personnel and the difficulty of "picking winners," as well as ample evidence of the inefficiency and ultimate unsustainability of investments where market incentives are inappropriate. Normally, using foreign aid resources to create appropriate conditions for cross-border transactions to take place spontaneously, rather than directly assisting specific business deals with aid funds, will have a more significant impact on economic growth and viable private sector development.

Providing A.I.D. funds with the primary goal of enabling a specific business transaction to take place may nevertheless be justified at times, provided that such a transaction is deemed likely to contribute meaningfully to furthering policy reform, promoting positive change in the business environment, or hastening the market response to such reforms. A highly visible transaction might, for example, serve one of these objectives by persuading the government to enact regulatory changes it has been reluctant to undertake or by providing a demonstration effect to other businesses which may have been loath to believe that recent policy changes would be sustained. As in the case of promotional assistance, care should be taken to ensure that A.I.D. assistance is not crowding out private service providers.

Because using foreign aid funds to assist a specific transaction by its nature means subsidizing one business rather than another, a proposal to achieve one of the above objectives in this way rather than through a more broadly focused intervention would need to show how this represents the most efficient means to achieve specific, measurable progress on one or more of those objectives.

V. Developing countries as a market for U.S. trade and investment

A. Promoting U.S. commercial interests abroad

The U.S. economy relies increasingly on exports, which account for a substantial segment of job growth in this country. The objectives of U.S. trade policy described in III. above reflect a recognition of the critical and growing importance of exports for the U.S. economy and U.S. jobs. On a more immediate level, the U.S. also conducts a number of programs whose primary purpose it is to directly promote U.S. commercial interests, by assisting individual U.S. firms to develop export and investment markets worldwide:

- The Department of Commerce, through the United States and Foreign Commercial Service and other mechanisms, works to develop U.S. export and investment potential and information for U.S. firms on penetrating foreign markets.
- The Export-Import Bank finances U.S. exports through a variety of direct loans, loan guarantees, and insurance programs, in order to enable U.S. exporters to meet the competition of foreign exporters who receive subsidies from their governments.
- The Overseas Private Investment Corporation (OPIC) insures U.S. investors in developing countries against risks of war, expropriation and currency inconvertibility, to promote mutually beneficial investments that might not otherwise take place. It also provides direct

loans, equity investments and limited loan guarantees for overseas private ventures.

- The Trade and Development Program (TDP) provides grants for feasibility studies on projects in developing countries which have a high probability of requiring follow-on exports from the U.S.

In addition, Department of State economic officers increasingly perform a commercial function in addition to their economic reporting responsibilities.

B. The role of A.I.D. in supporting the U.S. economy

It is often assumed that foreign aid is a net drain on the U.S. budget and economy. In fact, building open and prosperous economies in the developing world is increasingly important to the economic prosperity of the United States. Developing countries account for a large and growing share of U.S. exports. It is precisely those newly industrializing countries which have opened up their economies and liberalized their trade policies -- in East Asia and now increasingly also in our own hemisphere -- which are proving to be the growth area for U.S. exports and investment.

Recent A.I.D. research has borne out the linkage between increases in U.S. exports and liberalization in developing country economies. This research shows that U.S. exports have increased far more to A.I.D.-assisted countries undertaking programs of reform than to nonreforming countries: in the latter half of the 1980s, U.S. exports to A.I.D. recipients undertaking policy reforms increased at a rate more than double that of U.S. exports to non-reformers. By placing strong emphasis on programs and projects designed to improve the policy and business environment in these countries, A.I.D. is therefore benefiting the U.S. economy as well as the recipient country's economy by helping move LDCs into a more mature economic partnership with our country.

To see foreign aid as either helping develop the poor countries of the world, or helping the U.S. commercially, is a false distinction. Economic growth in developing countries, which a well designed foreign aid program can foster, has an indirect but powerful impact on U.S. exports, and on the jobs they create, although it may at times be difficult to detect these positive changes in the short run. A.I.D.'s work in developing countries should be seen as part of a continuum of programs which contribute positively to overall U.S. trade policy goals, helping provide the framework within which more direct commercial promotion programs such as those cited above can yield positive results for U.S. business. Sometimes A.I.D.'s development goals overlap with these agencies' more direct commercial objectives, and in such cases missions should cooperate actively and constructively with these agencies.

C. Tied aid and mixed credits

All donors, the U.S. included, to a greater or lesser extent tie the provision of their development aid to procurement from their own suppliers. What this means in practice is different according to the shape of the particular donor's program. Many other donors devote a large proportion (up to 40% of aid commitments) of their aid to financing capital projects which often have been identified by the would-be investor or supplier, combining commercial and development motivations in their aid programs. A popular financing method for such capital projects has been to mix concessional aid resources with government export credits (tied aid, or mixed, credits) in order to provide more favorable financing terms to one's home country exporters.

By contrast, development professionals in the field identify and program U.S. aid funds, resulting in a high proportion of technical assistance in the social sectors, food aid, and policy-based program assistance. Less than 10% of U.S. aid is dedicated to capital projects. In international negotiations, the U.S. has maintained a consistent strategy of working to restrict the trade- and aid-distorting practice of mixed credits, so as to level the playing field on which U.S. exporters compete and ensure greater effectiveness in the use of aid resources. To that end, in the 1980s the U.S. established an extremely limited mixed-credit program (the "War Chest") to serve as a credible deterrent while it continued to press others in negotiations to agree to restrictions on the use of tied aid credits. In 1988, the U.S. succeeded in negotiating in the OECD an increase in the concessionality level of tied aid credits from 25% to 50% for Least Developed Countries (LLDCs), and from 25% to 35% for other developing countries. This made it more expensive for donors to engage in such practices.

In 1991, the U.S. scored a further victory when donors concluded the "Helsinki V" agreement in the OECD. For projects of under 80% concessionality whose total financing package is above SDR 2 million, this agreement:

-- prohibits tied aid credits for exports to upper middle-income countries (per capita income of $2465 or above);

-- prohibits tied aid credits to middle income countries unless a project is not commercially viable; and

-- requires OECD consultation on all projects above SDR 50 million.

The 1988 requirements for minimum concessionality of 50% for projects in LLDCs and 35% concessionality in middle-income countries from the 1988 agreement also remain in effect.

The Helsinki Agreement represents an important victory for the U.S. negotiating strategy of reducing the distorting effects of tied aid credits on development aid and opening new markets to U.S. exporters who have been disadvantaged by foreign exporters' subsidized financing. The success of Helsinki will depend upon the outcome of the system of "challenges" by one donor of the commercial viability of another's project proposals. The U.S. strategy is to use this agreement to reduce mixed-credit proposals by donors and the use of aid resources to lower the cost of financing capital exports.

Consistent with this approach, A.I.D. will not seek to compete with other countries' tied aid credit programs by using aid resources to subsidize U.S. exporters. Missions should continue designing and developing capital projects to meet individual countries' priority development needs, with help as appropriate from A.I.D./W, but A.I.D. will not promote capital projects as an end in themselves to compete with other donors' commercially-motivated programs.

If in future defensive "War Chest" interventions are needed in support of U.S. negotiations to further phase out tied aid credits, A.I.D. will cooperate with Treasury, Exim and other concerned agencies to that end while keeping such programs distinct from its other aid programs.

VI. A.I.D. programs and U.S. trade policy

A. A.I.D. involvement in U.S. trade policy decisions

Trade looms far larger in resource flows to developing countries than does aid, and has much greater prospects for increasing over the coming years. Likewise, trade barriers against LDC exports can inflict serious damage on their economies. U.S. trade policy, through decisions about trade sanctions, quotas, access to preferential trading arrangements, and the like can have a far greater impact on developing country economies than U.S. aid policies.

U.S. trade policy decisions are made through a process of inter-agency dialogue reflecting a variety of U.S. interests. By participating actively in this decision making process, A.I.D. can bring its development perspective, in-country and sectoral expertise to bear on U.S. policy decisions which otherwise are unlikely to take their impact on developing countries into account. Developing countries represent a large and growing market for U.S.

exports, but trade policy decisions are rarely made with a long-range time perspective which considers the growth prospects of potential markets. A.I.D. is in a position to bring this perspective to the table. Moreover, participating in U.S. trade policy decisions allows A.I.D. to "capture" information on impending trade negotiations and decisions which could have a significant impact on development in A.I.D.-assisted countries and therefore need to be considered in our program design.

The Office of the U.S. Trade Representative (USTR) directs the Administration's trade policy, and chairs the inter-agency Trade Policy Review Group (TPRG) and Trade Policy Staff Committee (TPSC). Although A.I.D. has a seat on both these committees, its participation has not been consistent and its voice is therefore often not heard on issues of relevance to developing countries. Given the growing importance of trade to developing countries and A.I.D.'s professional expertise, A.I.D. needs to develop a more complete knowledge base concerning U.S. trade policy decisions with an impact on A.I.D.-assisted countries and boost its participation in U.S. trade policy decisions affecting developing countries.

B. U.S. trade policy and A.I.D. development programs

Developing countries are increasingly recognizing that "special and differential treatment" in the GATT has not served their needs or their long-range development well. They are now embarking on programs of unilateral liberalization and seeking entry as equal members of the GATT in increasing numbers. A.I.D. programs can and should help these countries sustain their movement toward free and open markets and their integration into the world trading regime. The approach laid out in section IV. provides the framework for A.I.D. assistance to help bring countries into the world economy, laying the groudwork for them to take their place as trading partners with the United States.

At a more detailed level, A.I.D. has a special responsibility to ensure that the programs and projects it develops with host countries not only adhere to Congressionally mandated trade laws (e.g. sensitive export sectors) but also are consistent with U.S. trade policy and with U.S. commitments in the GATT or other trade and investment agreements. Moreover, at times A.I.D.-assisted countries may need special technical assistance to enable them to participate in international trade negotiations leading to trade liberalization. It will not be appropriate at all times and in all cases to provide assistance to bring countries into line with individual aspects of U.S. trade policy, but where U.S. trade policy interests coincide with the development priorities of a particular A.I.D.-assisted country (e.g. strengthening intellectual property rights, establishing norms and standards, or upgrading customs valuation procedures) A.I.D. missions should incorporate such factors into the design of policy or regulatory reform programs.

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