

DEVELOPMENT CO-OPERATION DIRECTORATE
TRADE DIRECTORATE

AID FOR TRADE: HOW TO MAKE IT EFFECTIVE

**Meeting of the Working Party of the Trade Committee, 9-10 May 2006,
Joint Meeting of the Development Assistance Committee and the Working Party of the Trade Committee,
1 June 2006**

This joint note is submitted for COMMENT and DISCUSSION to the 9-10 May Working Party of the Trade Committee. It will be submitted for APPROVAL to the 1 June 2006 Joint Meeting of the Development Assistance Committee (DAC) and the Working Party of the Trade Committee.

The note is the second OECD contribution to the international consultations on appropriate mechanisms to ensure additional financial resources for Aid for Trade, which were called for in the WTO Hong Kong Ministerial Declaration. It examines the challenges of improving the effectiveness of donors' aid-for-trade programmes and develops proposals for a framework for a country-based aid-for-trade partnership.

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Mr Frans Lammersen – Tel: +33 (0) 1 45 24 89 88 – E-mail: frans.lammersen@oecd.org
Ms Martina Garcia – Tel: +33 (0) 1 45 24 13 82 – E-mail: martina.garcia@oecd.org
Mr Masato Hayashikawa – Tel: +33 (0) 1 45 24 16 92 – E-mail: masato.hayashikawa@oecd.org

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EXECUTIVE SUMMARY

The Hong Kong WTO Ministerial Declaration calls for the expansion of aid-for-trade to help developing countries benefit from WTO agreements and more broadly expand their trade. It is within this context that the WTO has asked the OECD to contribute to these efforts, and in particular to examine the following three issues: (1) how much aid do donors already provide in support of trade; (2) how effective are these programmes; and, (3) how to make aid-for-trade an effective tool for helping developing countries, particularly LDCs, to fully benefit from trade liberalisation and WTO Agreements.

A first paper argued that there are trade-offs between the scope of the agenda, the volume of aid commitments, and managing these commitments to deliver results. It argued that the very large overlap between the economic growth and the trade agendas would reduce the benefits from further differentiating trade-related assistance from the categories already included in the aid-for-trade agenda, such as economic infrastructure. Increasing the capacity of less-advanced developing countries to become more dynamic players in the global economy will require a wide range of support. The scaling up of aid provides room for this, but it is the responsibility of these countries to accord more priority to their trade and growth strategies in order to effectively accelerate their successful integration into the world economy, a process which donors are willing to support.

This second contribution builds on these conclusions, in particular, concerning local ownership of the development strategies. The note reviews trade related technical assistance and capacity building programmes against the principles of the Paris Declaration on Aid Effectiveness. Next, it draws policy recommendations on ways to strengthen the effectiveness of aid-for-trade programmes and suggests a country-based mechanism to monitor and review the contribution of these programmes to help countries benefit from trade liberalisation and WTO Agreements.

The process of building internationally competitive economies takes time and is highly country specific, but there are a number of common features for designing comprehensive strategies to promote dynamic and broad-based growth through trade while minimising short-term economic and social adjustment costs. The benefits of trade and trade liberalisation will only be fully realised in a broad policy framework that allows labour and capital to move from declining to expanding areas of activity. For low-income countries, the policy mix will need to direct particular attention to fostering an appropriate macroeconomic framework, improving access to finance, developing human capital, strengthening infrastructure and related services and reducing their own often high barriers to trade. Donors, in addition, can provide valuable assistance in helping developing countries to create an enabling environment that allows local firms to operate on a level-playing field and strengthens their competitive capacities in international markets.

In general, the economic rationale for government intervention is to improve equity and efficiency. The rationale for aid-for-trade assistance is based on equity concerns at the global level but on efficiency concerns at the local/country/regional level. Identifying the barriers that are restricting a nation's trade-related capacity has proven to be a challenge stretching the capability of most recipient and donor agencies. Moreover, aid-for-trade will face much of the same challenges inherent to all aid delivery. Harmonisation among donors and efforts to implement common arrangements, simplify procedures, an effective division of labour and collaboration are key aid effectiveness principles. Recent evaluations of aid-for-trade programmes highlight, in particular, the absence of explicit targets in most projects and the poor use of monitoring and evaluation tools.

The main challenge, however, remains the lack of genuine country ownership towards making trade a key tool of economic development. Trade reform is extremely sensitive to political economy constraints, and in many countries, the political and economic elites are unwilling to promote the reforms needed. In these cases, national dialogues and mainstreaming trade into national development strategies will remain weak. Donors seeking to deliver developmental results may want to focus on capacity building and improve their understanding of the political and institutional constraints to assess the capacity of the private section and local champions in and outside of existing political and business elites in helping to define country strategies. The inclusion of aid-for-trade in the Hong Kong Declaration offers the aid and trade communities the opportunity to establish a framework for aid-for-trade assistance providing incentives to recipients and donors alike to:

- Foster integration and synergies between trade and other economic policy areas;
- Improve the coherence of aid-for-trade assistance with overall aid strategies;
- Enhance the credibility of donors' commitment to increasing aid-for-trade;
- Support knowledge development in recipient and donor countries, and;
- Strengthen country ownership, align around country strategies, harmonise donor procedures and enhance management for results and mutual accountability.

Some commentators are advocating the creation of a Global Facility for Trade. Specific vertical funds can be a useful mechanism to channel financial resources towards needs that can be easily de-linked from broader national development strategies. However, it is undesirable, if at all possible, to separate the trade-related agenda from the broader economic growth agenda since this may compromise aid effectiveness. Prioritisation of trade capacities gaps can only be achieved effectively and efficiently when trade is mainstreamed into national development strategies. Moreover, a broad interpretation of aid-for-trade represents around a quarter of net ODA, and there are strong signs that donors' interest in this agenda will result in additional ODA. Thus, efforts should instead focus on further integrating aid-for-trade into locally owned development strategies that are being developed to support the scaling up process at the country level.

While there are compelling reasons to refrain from creating a new institutional mechanism for the financing and allocation of aid-for-trade, there is a very clear need to establish effective coalitions at the country level to i) strengthen the monitoring and review processes; and ii) increase both donors' and recipients' transparency and accountability of the assistance provided and the results obtained. A more structured Aid-for-Trade Partnership should be country-based, cutting across several ministries, and include monitoring and evaluation mechanisms with reporting responsibilities. This would increase both the accountability of donors in terms of the financial resources provided and the joint accountability (*i.e.* donors and recipient countries) for results. A partnership involving all country-based aid-for-trade practitioners would provide incentives and means to foster country ownership, donor alignment and harmonization. As sketched out in the final diagram, an obligation to report regularly, for example to the WTO, the results of the assistance should also help to focus minds on prioritising results-based management approaches. More traditional donors' evaluations are important to ensure the dissemination of best practice across countries, and increase transparency on pledges and commitments. Given the technical challenges of using aid to improve export competitiveness and the urgent need to improve know-how in both recipient and donor countries, there is a need for a more informal mechanism dedicated at developing tools and methods to build trade capacity where aid-for-trade practitioners could meet and work jointly free from the donor-recipient relationship present in most other forums.

AID FOR TRADE: HOW TO MAKE IT EFFECTIVE

1 Introduction

1. The Hong Kong WTO Ministerial Declaration calls for the expansion of aid-for-trade to help developing countries benefit from WTO agreements and more broadly expand their trade. It is within this context that the WTO has asked the OECD to contribute to these efforts, and in particular to examine the following three issues: (1) how much aid do donors already provide in support of trade; (2) how effective are these programmes; and, (3) how to make aid-for-trade an effective tool for helping developing countries, particularly LDCs, to fully benefit from trade liberalisation and WTO Agreements.

2. A first paper argued that there are trade-offs between the scope of the agenda, the volume of aid commitments, and managing these commitments to deliver results. It argued that the very large overlap between the economic growth and the trade agendas would reduce the benefits from further differentiating trade-related assistance from the categories already included in the aid-for-trade agenda, such as economic infrastructure. Furthermore, the capacity of the WTO in advocating, monitoring and delivering this agenda will also need to be taken into account when considering the strategic priorities to be targeted in a Doha aid-for-trade initiative. Finally, the paper argued that increasing the capacity of less-advanced developing countries to become more dynamic players in the global economy will require a wide range of support. The scaling up of aid provides room for this, but it is the responsibility of these countries to accord more priority to their trade and growth strategies in order to effectively accelerate their successful integration into the world economy, a process which donors are willing to support.

3. This note provides the second OECD contribution to the debate. It reviews the effectiveness of donor programmes supporting developing countries in: i) trade policy making at the national level; ii) participation in WTO negotiations; iii) implementation of WTO agreements; and iv) addressing supply side constraints, such as institutional reform and infrastructure. The objective of this second exercise is to draw the main policy recommendations emerging from this analysis, and in particular from the key lessons from the OECD Trade and Structural Adjustment project and from existing guidelines on aid effectiveness for the benefit of future aid-for-trade programmes in the context of the DDA and wider trade and development programmes.

4. A vast amount of evidence indicates that the potential benefits of multilateral trade liberalisation are substantial for developing countries. Openness to trade, when coupled with domestic reform and stable macro-economic policies plays a key role in fostering sustainable economic development, employment opportunities and poverty reduction. This has been illustrated in a number of developing countries that have achieved impressive economic growth rates and substantial reductions in poverty. At the same time, many low income countries are facing serious difficulties in adjusting to trade liberalisation and capturing the benefits of more open markets. In these countries, governments, institutions and enterprises often lack capacities, *e.g.* information, policies, procedures, institutions and/or infrastructure, to compete effectively in global markets and take full advantage of the opportunities that are provided through international trade. This is particularly true for the Least Developed Countries (LDCs) whose share in world exports of goods and services was only 0.63 percent in 2004.

5. Increasing the capacity of low and middle income developing countries to become more dynamic players in the global economy clearly requires a wide range of support. Donors are already providing a

substantial amount of ODA to improve these countries capacity to trade. In fact, since the end of the Uruguay Round in 1994 donors supported the wider aid-for trade agenda with almost a total of USD 200 billion of ODA, with the largest share going to building infrastructure and productive capacities and some US\$ 20 billion spent on trade related technical assistance and capacity building.¹ The projected scaling up of ODA to USD 130 billion in 2010 will provide ample room to increase these amounts even further.

6. However, given the already relatively high volume of aid that is targeted at trade-related activities, the key value-added of the aid-for-trade initiative might well lie in improving the effectiveness of trade-related assistance and strengthening its links with the wider economic growth agenda. The revamping of the Integrated Framework, lessons from evaluation exercises of the traditional trade related technical assistance and capacity building and the Paris Declaration on Aid Effectiveness together with general public spending best practices offer the aid and trade communities a framework to develop common practices for improved results in this area of development co-operation.

7. This note discusses how to make aid-for-trade an effective tool for helping less developed countries benefit from WTO Agreements and access to international markets. It is structured as follows:

- Section 2 provides a brief overview of key challenges of trade reform in developing countries. It notes that while the process of building internationally competitive economies takes time and is highly country specific there are a number of common features for designing comprehensive strategies to promote dynamic and broad-based growth while minimising short-term economic and social adjustment costs.
- Section 3 highlights the problems related to identifying market failures that can be effectively addressed by government interventions. It suggests that identifying the binding market or government failures that are constraining a nation's trade-related capacity is a challenging exercise that will stretch the capability of most recipient and donor agencies.
- Section 4 describes the aid effectiveness principles agreed upon in the Paris Declaration such as donors' commitments to align their assistance with partners' strategies, to harmonise their policies and procedures, to focus cooperation programmes on desired development results, and to rely on and strengthen partner countries' monitoring and evaluation systems in order to track progress.
- Section 5 reviews a number of donor programmes to strengthen trade capacity against the established principles on aid effectiveness.
- Section 6 identifies three main priority areas to improve the effectiveness of aid-for-trade, *e.g.* establishing a national dialogue to formulate and implement trade policy, mainstreaming trade policy into national economic development and external assistance strategies, and better adapting donor programmes to recipient's characteristics.
- Section 7 addresses the challenges of managing the scaling up of aid-for-trade in particular with respect to absorption capacity constraints and the potential for Dutch disease.
- Section 8 develops proposals for strengthening the aid-for-trade framework, and in particular for providing further incentives to apply aid effectiveness principles and increase accountability.

1. COM/DCD/TD(2006)2

2. Trade reform in developing countries: key challenges

8. Successfully managing the liberalisation of the domestic economy entails major challenges for many low-income countries, which often rely on import tariff revenues and, mostly unprocessed, primary-commodity exports. Despite major reform efforts and market-opening initiatives in the 1980s and 1990s, many of these countries were unable to exploit emerging market opportunities at the regional and global level and hence did not realise the full benefits of trade liberalisation. This section briefly addresses some of the key challenges low-income countries face in liberalising their trade policy and adjusting their economy to increased global competition. It will highlight some successful examples of structural adjustment in developing countries that have resulted in the emergence of non-traditional, dynamic export sectors. Finally, the section draws attention to the role donors have played in helping these countries respond to increased trade opportunities.

9. Trade liberalisation prompts changes in relative prices that, in turn, trigger structural adjustment, which occurs as more productive firms -especially export-oriented- expand their outputs coupled with a contraction of less productive enterprises in sectors that become subject to greater import competition. As trade patterns change, workers lose their jobs and must seek reemployment in expanding sectors, while capital might also lie idle for a period. In many developing countries, adjustment is constrained by the degree of rigidities in the economy and export patterns (*e.g.* dependence on a few export commodities and markets). It is particularly costly for affected workers who lack effective social safety nets. Also the costs of implementing new WTO agreements can be disproportionately higher in developing countries where previous practice and regulation might differ substantially from the international standards.

10. Adjusting to changing conditions, whether due to international or purely domestic shocks entails a process in which the costs are weighed against expected future benefits and, as it is well-established, risk aversion increases inversely with income levels. Undertaking reforms across different policy areas simultaneously can reduce resistance to change, because those adversely affected by one reform might benefit from another. At the same time, cross-policy synergies may occur. Thus, it follows that governments should seek, to the greatest extent feasible, to pursue policy reforms in parallel. Comprehensive reform programmes are thus likely to be more effective than piecemeal strategies, although no blueprint exists.

11. Many policy initiatives have been advanced as the pivotal prerequisite of structural adjustment: trade liberalisation, to ensure resources do not migrate to protected sectors; investment liberalisation, to ensure a macroeconomic multiplier effect; industrial relations reform, to ensure labour market preparedness; competition policy reform to avoid abuses of dominant position in post-deregulation markets. In fact, the actual sequence of these and other policies depends on what is politically feasible in the country concerned. Notwithstanding the differentiated nature of the adjustment challenge between countries, many of the countries that did successfully take an outward-oriented growth path and restructure their economies did so by securing macroeconomic stability through sound fiscal and monetary policies, removing anti-export bias, adopting an appropriate exchange rate policy and improving their governance structure (OECD, 2005b).

12. A recent study (OECD, 2005b) on the expansion of the agro-food industry in Chile, the cut flowers industry in Kenya, the garments industry in Lesotho and in Mauritius, and the seafood industry in Thailand presents examples of structural adjustment, which have resulted in the emergence of non-traditional, dynamic export sectors. The case studies suggest that while the underlying forces that prompt economies to adjust vary from one case to another, a number of critical requirements for successful structural adjustment are common to all. These include macroeconomic stability; trade and regulatory reforms that stimulate exports, improve local business conditions and foster competition, thereby also promoting private domestic and foreign investment; long-term investments in human resources and

infrastructure; adequate support structures to assist firms to adapt, upgrade and connect to export markets, and a proper sequencing of reforms (both economy-wide and sector-specific) that can help sustain the structural adjustment process. Hence, a key factor for successful adjustment has been the pro-active role of government in establishing an enabling economic and policy environment that allows local firms to operate on a level-playing field and strengthen their competitive edge in international markets.

13. Bangladesh's experience in opening its textiles sector gives strong support to the need for broad-based reform in order to reduce dependence on tariffs as a source of government revenue in the face of trade liberalisation. Bangladesh, a developing economy heavily dependent on tariffs as a source of revenue, has successfully addressed trade-related structural adjustment by reforming its domestic tax regime to compensate for the declining tariff revenues resulting from trade liberalisation and adopting a dynamic macroeconomic policy framework to maintain fiscal discipline necessary to support exchange rate liberalisation (OECD 2005b). The aid-for-trade dimension could then also arise *via* assistance with tax reform or, in general, with managing a sound macroeconomic policy.

14. In the case studies mentioned above, foreign investments also provided an important “qualitative” contribution. Foreign direct investment and expatriate expertise supplied capital, managerial and technological know-how, as well as access to foreign markets and buyers. For example, both donors and the private sector provided assistance to develop cut flower expertise in Kenya, the clothing industry in Mauritius and Lesotho, the fruit packaging techniques in Chile and shrimp farming in Thailand. In Africa donor assistance aimed at increasing the productivity and competitiveness of the local private sector underscores the importance of placing greater emphasis on the development of human capital (including organisational and entrepreneurial skills) (OECD, 2006c). The key ingredient in the success of Asian countries, for example, has been the continued upgrading of their productive capabilities. The capacity to produce higher value products, as Bhagwati (2002) points out, depends more on the skills of a country's workers and the quality of its institutions than on any natural endowments. In this respect, the problem in Africa is not that insufficient elements for export success exist, but that they have lacked catalytic agents (*i.e.* effective local enterprises and institutions) that put a cumulative process in motion. Thus, the less advanced countries might require concerted efforts to improve their supply-side capacities, to diversify economic activity and to build sound institutions so that these countries can begin to avail themselves of the full range of policy options.

15. And as with the successful countries, the strategies and interventions needed to become dynamic participants in the global economy will be highly country specific, both because of different resource endowments and geographical situations and because of different institutional and political economy contexts. Thus, these strategies have to be home grown and depend on strong local leadership from the top and wide participation from across the economy. There is wide scope for sharing of experiences by the successful developing countries who have managed, through this approach to foster the kind of fast “catch-up” economic growth possible in a global economy.

3 Effective government interventions

16. In general, the economic rationale for government intervention is to improve equity and efficiency. The rationale for aid-for-trade assistance is based on equity concerns at the global level but on efficiency concerns at the local/country/regional level. The main cause of inefficiency lays where circumstances mean that the private returns which an individual or firm receives from carrying out a particular action differ from the returns to society as a whole. Market failure is a description of a situation where, for one reason or other, the market mechanism alone cannot achieve economic efficiency. This can occur in the case of public goods, externalities, imperfect information, or market power from insufficient competition. Correcting market failures is essential to ensure that government intervention creates a

‘supply-side’ or ‘structural impact’ which alters the productive capacity of the economy by for example improving the working of markets and economic institutions or strengthening capacities.

17. Identifying market failures, however, is not always straightforward. For example, a well-known supply constraint in many low-income countries is the lack of access to credit. The World Bank annual *Doing Business* reports uses as a proxy for quantifying this problem the availability of credit information registries. If banks cannot access information about the creditworthiness of potential clients, they will rely on social and ethnic networks, constraining the expansion of new businesses without privileged connections. However, Bigsten and Söderbom (2005) in their review of manufacturing enterprises find that despite the fact that financing is the top constraint cited by company managers in Africa, investment by companies remains unrelated to retained profits and that the desire for formal credit is relatively modest among medium and large businesses. The most likely explanation for why credit (or the lack of credit) has not been a major factor in explaining why investment has been low over the last decade is that during this period few firms in these countries could identify strong investment opportunities. In Bigsten and Söderbom (2005) view, the high level of economic and political uncertainty coupled with the very thin markets for second hand fixed capital are much more important factors than the lack of formal credit. This is why so many of the financial system reforms implemented in Africa in the 90s appeared ineffectual, *i.e.* reforms did not address the binding constraints.

18. Furthermore, what appears at first sight as a market failure may be in fact caused by a government failure. Indeed, governments, particularly those with weak institutional capacity and low levels of civil society scrutiny might produce inefficient solutions. For example, some argue that under-investment in trade-related administration and infrastructure is partly due to the public good characteristics of such investments on other countries. There is no doubt that the impact of transport infrastructure is an essential determinant of export competitiveness and has significant externalities to neighbouring countries. Limão and Venables (2001) estimate that the median landlocked country faces transport costs about 50% higher than the median coastal country and that as a result its trade volume is 60% smaller. However, Evenett (2005) remarks that it might be misleading to think about the rationale for under-investment in an activity as independent of the levels of investment in other areas that affect the export competitiveness of developing country firms. He argues that sub-optimal outcomes in any one component of a nation’s trade-related capacity might reduce the returns expected from investing in other components. For example, one could easily envisage that the investment returns from a new port are greatly reduced by the existence of a corrupt and inefficient customs service – a typical government failure.

19. Consequently, identifying the binding market or government failures that are constraining a nation’s trade-related capacity is a challenging exercise that will stretch the capability of most recipient and donor agencies. Among donor agencies there has been a concerted effort to improve the analysis of capacity gaps in developing countries. For example, the Trade Diagnostic tool of the Integrated Framework helps LDCs to analyse where government intervention will be most helpful. In addition, the World Bank has decided to further develop its capacity to assess trade-related capacity gaps. Integrating economic growth and trade into national poverty reduction strategies will be essential to help in identifying the interplay between different constraints and the most binding ones. However, while these tools are vital to help the poorest countries build a coherent national trade policy and identify priority areas, they are often still too general to provide the detailed analysis necessary to ensure a successful intervention. Identifying a need is not sufficient to ensure successful interventions that will increase productivity. If corruption is the problem, investing in ports without reforming the customs service will allow customs officials to capture a larger rent instead of delivering lower transport costs. Further mechanisms to improve the ‘know-how’ of aid-for-trade practitioners from recipient and donor countries seem required.

4. When is aid effective? The Paris Declaration on Aid Effectiveness

20. Experience both in developed and developing countries' public sectors show that complex assistance programmes have the potential to consume large amounts of administrative resources and tend towards answering the needs of the programme providers instead of the priorities of the targeted population. In the last decade, many OECD countries have focused their public sector reform efforts on improving the delivery of public services through expanding the use of performance and project management tools, such as joint-up government, stakeholders' consultations, outcome-based targets and in-built evaluations. Equally, the development community has developed a vast body of best practice on delivering aid effectively. This section sets out these practices and principles that were agreed upon in the Paris Declaration on Aid Effectiveness (OECD, 2005a).

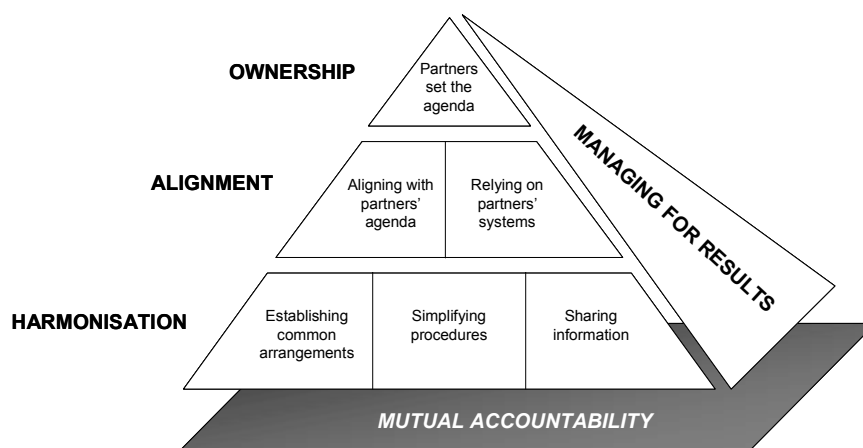
21. In the Monterrey Consensus (UN, 2002), the global community affirmed the importance of development to the world's well-being and called on developing countries to strengthen their commitment to policies and institutions that can stimulate growth, reduce poverty, and achieve the Millennium Development Goals (MDGs). As part of the follow-up, donors further committed to support such local ownership of development strategies, align development assistance with these local strategies, harmonise donors' policies and procedures, and implement principles of good practice in development cooperation. Furthermore, they affirmed their commitment to foster a global partnership on managing for results, agreed to aligning cooperation programmes with desired development results and to define how aid is expected to contribute to them, and decided to rely on and strengthen partner countries' monitoring and evaluation systems in order to track progress. Together, these international agreements define the principles of the aid effectiveness agenda, which can be summarised in five broad areas:

- i. **Ownership.** The development community will respect the right—and responsibility—of the partner country to exercise effective leadership over its development policies and strategies, and coordinate development actions.
- ii. **Alignment.** Donors will align their development assistance with the development priorities and results-oriented strategies set out by the partner country. In delivering this assistance, donors will progressively depend on partner countries' own systems, providing capacity-building support to improve these systems, rather than establishing parallel systems of their own. Partner countries will undertake the necessary reforms that would enable donors to rely on their country systems.
- iii. **Harmonisation.** Donors will implement good practice principles in development assistance delivery. They will streamline and harmonise their policies, procedures, and practices; intensify delegated cooperation; increase the flexibility of country-based staff to manage country programmes and projects more effectively; and develop incentives within their agencies to foster management and staff recognition of the benefits of harmonisation.
- iv. **Managing for Results.** Partner countries will embrace the principles of managing for results, starting with their own results-oriented strategies and continuing to focus on results at all stages of the development cycle—from planning through implementation to evaluation. Donors will rely on and support partner countries' own priorities, objectives, and results, and work in coordination with other donors to strengthen partner countries' institutions, systems, and capabilities to plan and implement projects and programmes, report on results, and evaluate their development processes and outcomes (avoiding parallel donor-driven mechanisms).
- v. **Mutual accountability.** Donors and partners are committed to enhance mutual accountability and transparency in the use of development resources. Partner countries will reinforce participatory processes by systematically involving a broad range of development partners when

formulating and assessing progress in the implementation of national development strategies. Donors will provide timely, transparent and comprehensive information on aid flows.

22. These five broad principles of the Paris Declaration on Aid Effectiveness are schematically depicted in a pyramid (see Figure 1). Whether read top-down or bottom-up, the pyramid provides insights about the harmonisation/alignment/managing for results agenda.

Figure 1. Partnership for Greater Aid Effectiveness



Source: An adaptation from Figure 1 of OECD (2004)

23. **Top-down.** Partners begin by setting the agenda for achieving development results and donors respond to this lead by aligning their support with the countries' results-oriented strategies and relying on partners' systems. At both of these levels, capacity strengthening and institutional development are essential. At the base of the pyramid, donors initiate the complementary actions of establishing common arrangements, simplifying procedures, and sharing information. At all levels of the pyramid, a focus on results is essential: the country's development agenda must be oriented toward the growth and poverty reduction results it expects to achieve.

24. **Bottom-up.** Read from bottom to top, the pyramid illustrates the stages of maturity in the aid relationship and the separable, but reinforcing, gains expected at each stage. In almost any circumstance, including in the most fragile country environments, the bottom-tier actions —adopting common approaches, simplifying procedures, and sharing analysis—can improve the impact of aid or at least reduce its costs. The ultimate objective is to move up the pyramid. In the most evolved country situations, partner governments not only establish clear priorities and results-based strategies, but also communicate how they want donors to collaborate and in what forms.

25. Aid-for-trade will face the same challenges inherent to all aid delivery. Harmonisation among donors and efforts to implement common arrangements, simple procedures, an effective division of labour and collaboration is a key aid effectiveness principle. Reducing administrative costs which can be extremely high in programmes based on a large number of relatively small activities is essential to enable recipient countries' administrations to increase their absorption and technical capacity. The main challenge, however, will be to implement performance management and use effectively evaluation and monitoring tools. Recent evaluations of aid-for-trade programmes highlight, however, the lack of explicit targets in most projects and consequently lack of effective monitoring. To be useful, targets need to be decided beforehand, be measurable ex-ante and ex-post, agreed upon by all actors, and accompanied by risk management strategies.

26. Summarising, there are no magical recipes to improve aid-for-trade projects. There is little specificity in aid-for-trade assistance that would justify radical changes in aid delivery best practice. Applying the aid effectiveness principles of the Paris Declaration is a prerequisite to improve the impact of aid-for-trade assistance. The foremost objective of specific projects should be to improve recipient countries' institutional capacity. This is necessary to ensure that recipient countries implement effective government interventions that result in improved trade capacity.

5. Reality check - Findings from evaluation exercises

27. A number of bilateral donors and multilateral agencies have recently reviewed their trade-related technical assistance and capacity building (TRTA/CB) programmes. Most conclude that the direct effects of these assistance programmes on export (growth) volumes have been rather difficult to substantiate. The most widely cited positive outcomes of trade-related donor assistance include improved understanding of the potential contribution trade can have on development, increased awareness and knowledge of trade policy issues (including WTO-related), and strengthened national dialogue. This section reviews a number of these evaluations in relation to the aid effectiveness principles.

28. A recent review of forty-five case studies from economies around the world on how they managed the challenges of WTO participation notes the key importance of country ownership and national dialogue. [(WTO, 2005) Key domestic stakeholders (government, business and civil society) need to manage the pace and nature of their country's integration into regional and global markets and thus take full advantage of participation in the WTO. At the same time, the case studies also clearly show that there is a 'threshold' level of institutional capacity and resources that are needed to implement WTO agreements and maintain an effective presence 'at the table' of WTO negotiations. Beyond that threshold, however, the key to successful management of participation in the global trading system is local ownership and dialogue: among government institutions, and between government and private sector institutions. Cases where a high level of interaction, information exchange and collaboration between major stakeholders was realised have been all 'success stories.' Cases where, for a variety of reasons, this collaboration and information exchange broke down, or where the priorities of the government and those of the private sector were mal-aligned, have derived little benefit from greater integration into the global economy

29. Beyond the key requirement of a national ownership and stakeholder dialogue, the case studies also highlight the need for strong political will and leadership from the highest levels as a prerequisite for a country to create a macro-economic policy environment conducive to private sector development and growth and development through trade liberalisation. Local ownership remains, however, rather weak in many low income developing countries. Under multi-donor initiatives, such as the IF, partner countries often failed to demonstrate strong leadership and political will for the reforms needed to underpin an effective trade development strategy, and the trade agenda seemed to have been driven mainly by the donors. Equally, bilateral donors have not always assessed trade-related needs in consultation with all relevant stakeholders, *e.g.* the private sector, while non-governmental stakeholders were not systematically consulted during the design and implementation of bilateral or multilateral programmes (OECD, 2006a)

30. In general, very few donors have used local institutions and country systems for their programmes. This was mainly due to weak local capacities in trade-related matters. Most of the programmes were not implemented in close consultation with all relevant partner country stakeholders and thus lacked well-defined roles and responsibilities of each entity involved in actual delivery. The exception has been the UK/DFID which channelled some of its aid through direct budget support. While most donors refrained from creating parallel structures for managing their programmes, they did not always use sufficiently local talents and institutions which would have helped strengthen local capacities. Instead most relied on the services of international experts/consultants and firms based in donor countries. The lack of

alignment, in some instances coupled with weak project management, has been a serious factor impeding the effectiveness of trade-related capacity development programmes (OECD, 2006a).

31. In principle, the aim of a multi-donor initiative, such as the IF or JITAP, is to foster and advance a harmonised approach to TRTA/CB. Yet, in practice, donors on the ground have had little success in designing and implementing complementary trade-related interventions through an integrated approach. Many donors often programmed their activities in isolation rather than in the framework of a broader comprehensive TRTA/CB programme. At field level donor co-ordination has been assessed as insufficient to ensure positive synergies between various interventions. For example, there are not many cases of joint project missions or evaluations. Furthermore, there are weak linkages between donors' multilateral activities (*e.g.* the IF and JITAP) and their bilateral activities at field level (OECD, 2006a).

32. Very few national development plans or poverty reduction strategies contained clearly defined trade-related objectives and/or performance indicators. Correspondingly, few donor-supported programmes were linked (or responsive) to partner countries' development strategies, nor were they assessed against country-owned objectives or indicators. However, donors themselves were not always effective at ensuring a results-based management of their own programmes and often lacked clear and measurable (multi-year) objectives and indicators. A number of reviewed donor programmes lacked information regarding the cost, timing or target per activity. This underscores the need for donors to improve their capacity on results-based management.

33. Similar recommendations have also been made regarding the operation of the Integrated Framework for Trade-Related Technical Assistance (IF) where its mandated review pointed to the shortcomings related to unclear definition of policy objectives, weak administration and co-ordination as well as lack of monitoring capability (World Bank, 2000). Subsequently, the six core agencies (IMF, ITC, UNCTAD, UNDP, World Bank, WTO) revamped the design and expanded the IF agenda to “mainstream” (integrate) trade into national development plans, such as PRS, through the preparation of country-specific diagnostic trade integration studies (DTIS)]. Even so, the independent IF evaluation that followed noted the high variability in the achievement of concrete trade outcomes in IF countries, and called for the development of a results-based management framework, with measurable goals and outcomes (Capra-TFOC, 2003). The most recent independent review of the IF again substantiates these findings, also noting the divergence in objectives and expectations between the intended beneficiaries and donors that have resulted in insufficient ownership (Agarwal and Cutura, 2004).

34. Some of these findings have been confirmed in the recent independent assessment of the World Bank support for trade and related policies. It notes that until recently the Bank has not had any formal trade capacity building strategy and that trade mainstreaming in its activities has been slow and uneven, calling for greater collaboration between the Bank's Trade Department and Country Management Units. To ensure that the Bank's advice on trade issues is consistent with its poverty reduction goal, the Bank's evaluation team recommends a more systematic assessment (*ex ante*) of possible trade-related poverty and distributional outcomes in all of its activities, particularly by drawing on the range of multidisciplinary expertise the Bank offers. Moreover, given the multi-sectoral nature of the current trade agenda the assessment calls for an enhanced cross-fertilisation between the various sector networks within the Bank (*i.e.* financial and private sector development, agriculture and rural development, and environmental issues) and the Trade Department. Finally, the evaluation recommends that the Bank strengthens its knowledge management activities (World Bank, 2006).

6. Priorities for Improvement

35. Based on the evaluation of past trade capacity building programmes, there are three main priority areas for improvement that have proven particularly difficult to tackle in the past:

- 1) Establishing a national dialogue to formulate and implement trade policy.
- 2) Mainstreaming trade policy into national economic development and external assistance strategies.
- 3) Aligning aid-for-trade with aid effectiveness principles.

6.1 *Dialogue among stakeholders*

36. The formulation and implementation of sound trade strategies and policies require a formal consultation mechanism or dialogue structure involving key stakeholders from the public and private sectors. This is needed to ensure sustainability of the process and linkages with national policy making. The objective of stakeholder consultation is to devise, based on consensus, a country-owned trade (development) strategy and a plan that identifies the priorities, roles and actions expected of national and external actors in implementing the strategy. Finally, a political commitment at the highest level of policy-making to a formal, on-going trade policy dialogue would demonstrate strong country ownership of the process, bolstering the dedication of mid-level officials, executives, and other participants in the policy process. That said, many developing countries, especially the LDCs, are short of business associations with sufficient capabilities to advance the interests of their members at the national policy making process, or in international markets. Often civil society groups are poorly organised and funded, with only limited access to policy-makers. Given the weakness of many business associations and civil society groups, a critical first step toward building effective stakeholder policy dialogue in some developing countries would be to support the development of private institutions that could act as effective interlocutors with government.

37. The second consultative process critical to effective trade policy is the one within developing country governments. Developments in international trade and investment today frequently have implications for the core work of ministries responsible for finance, infrastructure, social welfare, labour, economic planning, statistics, justice, and foreign affairs. The reverse is also increasingly true: policies formulated well beyond trade ministries have implications for trade. Yet officials in these disparate government departments do not always fully recognise the trade implications of the matters under their jurisdiction. To be effective, all the ministries and cabinet units whose work affects, or is affected by trade must be systematically engaged in trade policy discussions. In most cases, the formulation of trade policy is led by Trade Ministry whose limited capacity and prominence *vis-à-vis* more traditional planning ministries often explains the poor reflection of trade as a core aspect of country development strategies.

38. Cambodia is a good example of a developing country that appreciates the importance of forging effective partnerships with the private sector and dialogue with key stakeholders (policy-makers, business sector representatives, development partners and civil society groups) as an effective driving force to formulate a robust pro-poor trade sector strategy and hence the National Poverty Reduction Strategy (Siphana, 2003). In order to adopt a holistic, participatory and results-based approach to development and poverty reduction, the Government considers these mechanisms as vital in ensuring that both the national and international stakeholders at all times develop and work from a shared vision of objectives and goals. For instance, the Government has institutionalised a formal channel of policy dialogue, known as the Government-Private Sector Forum (chaired by Prime Ministers Office), through which systematic consultations between the public and private institutions are held.

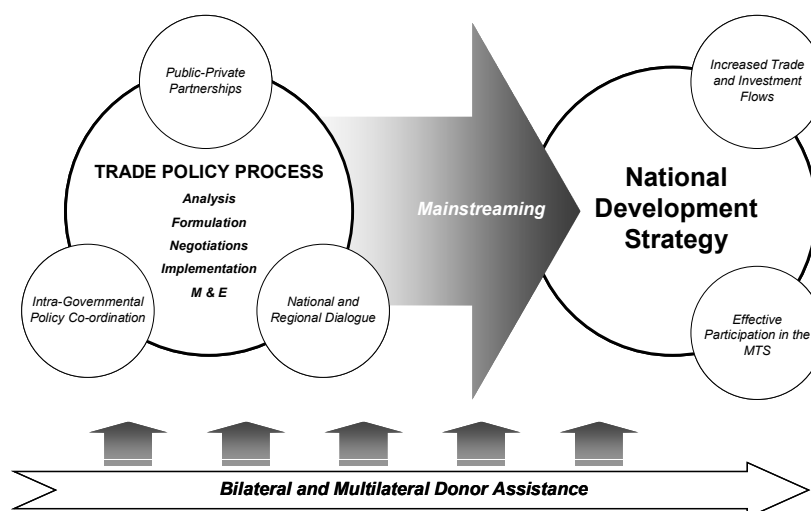
6.2 *Mainstream trade in national development strategies*

39. The breadth, complexity and continuing evolution of trade development challenges have led to a consensus that one of the principal objectives of trade capacity building should be to help developing countries put in place effective and sustainable trade policy frameworks and processes. Indeed, the record

suggests that no country has been able to achieve substantial gains in trade without an effective trade policy framework. There is no single way to structure the trade policy framework, and no two countries will adopt the same approach. Yet every country, regardless of the course it chooses, must master the same four-staged policy cycle: analysis and formulation of trade policy and strategy; preparation and execution of negotiating strategies; implementation of agreements; and monitoring and evaluation of policies and agreements. During all the stages of the mainstreaming process donors assistance can contribute to the effectiveness of the process, but cannot replace it. This cycle and the overall mainstreaming process are illustrated in Figure 2.

40. An effective national dialogue – as explained above – is essential to the formulation of trade policy and preparations of negotiating positions. These must be broadly inclusive, involving significant contributions from the enterprise sector and civil society and based on sound analysis. Governments must have a sophisticated understanding of the principal regional and multilateral agreements to which they are parties and of the international commercial developments that affect their economies. They must have the data collection and analysis capacities to understand the strengths and weaknesses of their economies as a whole, and the particular challenges facing individual sectors. Enterprises must have an understanding of their own competitiveness problems and a sense of the opportunities available to them in international markets. Civil society groups need a capacity to monitor the economic and social impact of trade-related policies and developments. A minimum level of joined-up government is necessary to assess the implementation costs from trade policy agreements and to monitor and evaluate international trade developments.

Figure 2. Mainstreaming Trade



41. Mainstreaming trade into national development strategies enables countries to identify the synergies and potential incoherence between their trade policy objectives and implementation and other economic and social policy areas. Mozambique is a positive example of a least-developed country committed to making openness to trade an integral part of its strategy to sustain rapid economic growth and alleviate poverty. In this context, aid-for-trade has been instrumental in helping Mozambique effectively mainstream trade and other trade-related measures and indicators in its medium-term poverty reduction strategy (known locally as PARPA). Moreover, aid-for-trade has helped Mozambique to: i) raise the awareness of the importance trade has on growth and poverty reduction; ii) stimulate public and private dialogues and partnerships; iii) address supply-side constraints; and iv) more fully integrate into the multilateral trading system. It is important to bear in mind, however, that there are a host of factors that shape and determine the outcome of a country's effort towards integration into the MTS, other than well-

targeted donor assistance. In the case of Mozambique, these include full endorsement at high political levels, effective intra-governmental policy co-ordination, as well as effective public-private partnerships (Siteo, 2005).

42. In addition, mainstreaming trade policy strategies into PRSs and Country Assistance Plans is a crucial step to signal to the donor community the recipient country's priorities. These plans are used as tools to coordinate assistance and reveal the potential synergies and overlaps with other areas of the development agenda be they economic or social. It is unclear whether the superficial integration of trade policy into PRSs systematically reflects lack of real domestic priority to the trade agenda. PRSs are a tool to obtain and manage assistance and the incentives for recipient countries will be to emphasise in these plans donors' priorities. The history of the PRSs and required focus on poverty reduction is not always conducive to prioritising the reforms needed for trade development, which tend to have complex and often indirect effects on poverty reduction. Thus, lack of mainstreaming into PRSs and CAPs might sometimes reflect a lack of political will for further integration into the world economy or a perception that donor priorities for this are not translated into effective support. Indeed, the evaluations' findings also highlight the weak integration of trade-related assistance in donor strategies. However, the increasing focus of donors on aid-for-trade should, by itself, provide stronger incentives to accelerate the mainstreaming process. This will help to ensure that the PRSP process does not translate into insufficient assistance channelled to aid-for-trade, as might have been the case in some LDCs where lack of capacity and overwhelming social (health, education) and political (conflict resolution) priorities have crowded out trade from their development strategies and thus, donor assistance programmes

6.3 *Improve practice on the ground: adapt donors' strategy to recipient characteristics*

43. The failure to apply systematically aid effectiveness principles is not specific to the TRTA/CB efforts. In fact, it is recognised that many donor agencies have few incentives to apply these principles. Their performance is too often assessed according to the levels of disbursements and not on the results obtained. In addition, there are two constraints that affect particularly aid-for-trade assistance: lack of technical capacity and lack of political will.

44. It is clear that aid-for-trade has suffered from a lack of know-how in both recipient countries and aid agencies. Diagnostic tools are relatively weak and have tended to over-rely on external consultants' analysis with little local input. This has often led to a superficial analysis of the binding constraints affecting trade and supply side capacity and relatively little thinking on the underlying reasons for these constraints and how aid might resolve them. Technical assistance has focused primarily on international trade policy – a key element to improve trade policy making, but it is unclear whether it has helped to improve countries' capacity to identify where aid or government intervention would be most beneficial. Mainstreaming trade into national development strategies and an effective dialogue will help to identify priority areas for action.

45. However, at the moment, it is unlikely that this process on its own is sufficient to ensure successful interventions, particularly when related to supply-side constraints. It is essential that the technical know-how of public intervention of aid for trade practitioners both in recipient countries and donor agencies increases significantly. The interlinkages of a trade development agenda and the domestic one are very complex. Increasing productivity through public intervention and subsidies is a particularly difficult area, prone to capture by vested interests. Lack of capacity is likely to be particularly relevant for export diversification programmes where the capacity of the private sector is also weak. When capacity gaps are likely to jeopardise the design and implementation of programmes it might be more effective to curtail support for existing capacity and instead focus on the missing elements through assistance to capacity building and maximising the role of regional institutions and donor's coordination. Intra-developing country cooperation in regional settings has most likely been an underutilised tool, in part due

to the difficulties of establishing regional institutions-donor legal relationships. However, such co-operation has the potential to facilitate reaching the ‘threshold’ level of institutional capacity and resources that are needed to implement the WTO agreements and maintain an effective presence ‘at the table’ of WTO negotiations, of technical capacity needed to design good government interventions, and crucially of identifying regional binding constraints to increase trade capacity.

Box 1. Transitional Assistance: Bananas in the Caribbean Islands

The reform of the EU Common Organisation of the Market in Bananas (COMB) from a tariff/quota to a tariff only regime will significantly increase the competition faced by traditional Caribbean exporters of banana from both other traditional ACP producers such as Cameroon and Ivory Cost and Latin American producers. During the 1990s banana exports from the Caribbean islands already declined considerably. In the Windward Islands, for example, they fell by 50%.

To assist the 12 traditional ACP banana suppliers (Caribbean and African) with the transition to the new market conditions, the EU adopted in a Special Framework of Assistance for Traditional ACP suppliers of bananas (SFA). This scheme was introduced for 10 years with the overall objective of either improving the competitiveness of traditional ACP banana production or supporting diversification wherever competitiveness is no longer attainable. The scheme consists of an annual allocation of around € 40 to 45 million divided among the 12 traditional producers according to a ‘competitiveness’ gap formula which provides more generous support to the least competitive countries.

In 1999, only 12% of the scheme was aimed at diversification from banana production. An evaluation report in 2000 of an earlier initiative, highlighting that only Ivory Coast and Cameroon could hope to compete with the most efficient Latin American producers prompted the European Commission to ask recipients to reconsider their strategies. By 2004, 64% of the funds were aimed at diversification. However, these percentages do not, in fact, reflect the reality on the ground. According to the evaluation report contracted by the Commission in 2004, only 27 % of commitments have been disbursed over the period, and resources dedicated to diversification were not used, revealing weaknesses in the diversification strategies of these countries. Moreover, the report concludes that the disbursed funding did not provide additionality, going mostly to large exporting businesses – the only ones able to anticipate the necessary investments needed for increasing productivity – and did not reach domestic small-holders where productivity levels remain much lower.

Although, the SFA was flexible enough to incorporate the lessons from past evaluations and change its activity focus, the allocation funding system did not adapt to the new diversification focus and the needs of the recipients. Moreover, the bottom-up approach consistent with country ownership principles was hindered by the lack of capacity and of political leadership – particularly regarding diversification efforts – failed to deliver the right selection of projects.

46. One issue of primary importance is that trade reform is extremely sensitive to the political economy of a country. In common with land reform and anti-corruption measures, it has a great potential to undermine the economic power of political elites and other vested interests. The more restrictive the trade and economic regime is the more entrenched vested interests will be. A successful integration into the world economy often demands considerable reform; there are very few countries where the binding supply constraints are only of a physical nature – solvable by a few hefty investments in infrastructure. Thus, in many cases, genuine country ownership of a pro-growth trade strategy will not be feasible in the short-medium term. This means that mainstreaming and dialogue are unlikely to take place or to be effective tools to develop a good strategy and donors will be unable to align their priorities with the recipient country. In such cases, different approaches, based on influencing behaviour through more direct work with the private sector will be necessary.

47. When state will is weak, projects aimed at building capacity in the private sector and civil society might perform better. Adapting initiatives such as the one village-one product approach developed by Japan’s Ministry of Trade and Industry to work directly with local authorities or the private sector can increase tangibly the benefits from trade, but also stimulate and strengthen the demand from the private sector and civil society for change and better policies.

Box 2. "One Village, One product" initiative

The "One Village, One Product (OVOP)" strategy is an adaptation of the *Isson-Ippin* movement which Japan initiated in 1979 to stimulate local economies through a participatory process. Each village or town drives the process by identifying, developing, and promoting a specific product or service in which it possesses a comparative advantage. The role of local authorities is to support those local entrepreneurs and enterprises developing the necessary capacities to innovate, develop brands and link their products to markets.

Similar movements under various names have sprung up in many Asian countries and are even spreading into regions outside Asia, for example, Africa. These movements help micro, small and medium enterprises to manufacture, offer and market distinctive products (e.g. handicrafts) or services through the use of locally available materials and local skills and talents. For example, OVOP projects in Nueva Ecija Province in the Philippines, supported by the Japan International Cooperation Agency (JICA) have "generated almost 2,000 new jobs and provided community-based employment for about 195 small communities."

Japan has recently embarked on a five-year (2005-2010) capacity-building project in Malawi, supporting the government in localising the OVOP movement. The core objective of the project is the empowerment of rural communities (by ensuring their participation in the activities) so that they are able to initiate and manage their own community-based development process through, e.g., OVOP. Other donors are also adopting OVOP principles, for example, the main approach of UNDP's Enterprise Mongolia Project, which assists local entrepreneurs to collectively develop a specialised and branded product. Japan is also supporting the OVOP Initiative in Mongolia through the Japanese Fund at UNDP, which will be implemented under the Enterprise Mongolia Project.

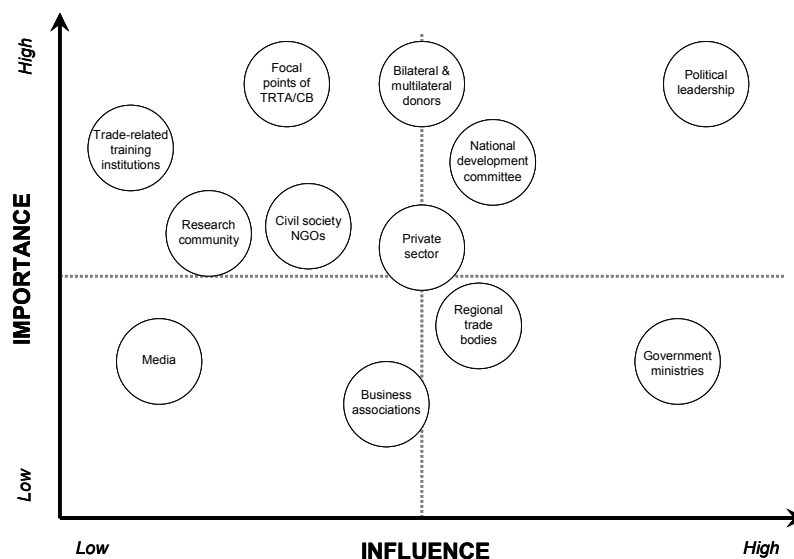
Japan has made the OVOP movement an integral part of its "New Development Initiative for Trade" which was presented at the WTO Ministerial Conference in Hong Kong in 2005 and focused on three areas of trade development support, namely, supply-side support ("PRODUCE"), distribution and export support ("SELL"), and market access for LDCs ("BUY"), with duty-free and quota-free market access for essentially all LDC products. The Initiative is a part of Japan's development assistance package announced at the G8 Gleneagles Summit, which aims to provide US\$10 billion over the next three years, as well as an exchange of a total of ten thousand trainees and experts during the same period.

48. Typically, donors have sought to facilitate change through technically sound programmes, supported in country by individual champions of reform or change. Increasingly the importance of understanding the underlying political systems and the mechanics of pro-poor growth has been acknowledged. The Drivers of Change (DoC) approach emerged as a way of applying political economy analysis to the development of donor strategy. The DoC approach seeks to identify the political institutions, structures and agents that can act as key levers to enable pro-poor change and therefore improve the effectiveness of aid. In particular, the role of institutions both formal and informal and underlying structural features is being recognised. For this reason DoC analysis focuses on formal and informal rules, power structures, vested interests and incentives within these institutions. The aim of the DoC approach is not to manipulate the local political economy, but rather to ensure that the country and donors understand the political economy obstacles. This can be facilitated by involving local research institutions and publishing the results of the studies. Some of the key benefits from the DOC studies already undertaken are: making explicit the assumptions behind programmes; clarifying the extent of 'political will' for reform and determining the risk this poses to a programme's success; identifying the role that the non-poor groups have in change processes, and suggesting collaboration with non-traditional partners, as well as discontinuing programmes that are unlikely to succeed at present.

49. Even when a thorough Driver of Change analysis is not possible or warranted – e.g. for small, very localised projects, tools such as stakeholder analysis might help to identify the key actors and institutions that need to own the objectives of the programme to ensure a minimum level of effectiveness. Stakeholder analysis typically divides actors into four groups according to how important the objective of the reform/programme/project is to them and how much influence they have over its design and

implementation. Figure 3 shows for illustrative purposes a hypothetical classification of key stakeholders in the formulation of a national trade policy.

Figure 3. An Illustrative Stakeholder Analysis Matrix



50. If insufficient ownership remains problematic and is likely to hamper the effectiveness of a programme, more time and resources into persuading sceptics to take ownership will be critical. Useful approaches might include creating pilot projects which deliver early results, formulating jointly the programme and enhancing transparency by publicly documenting performance.

51. In short, although the aid effectiveness principles of the Paris declaration are fully relevant to the aid-for-trade agenda, the political economy of trade and the difficulties of designing programmes that will enhance export competitiveness means that those principles cannot be applied blindly and systematically but that donors need to better adapt their approach and level of ambition to the country characteristics. Some of the most relevant guidelines for intervention come from the experience of working in fragile states. This does not imply that they should only be applied in fragile states but in countries where the political economy is jeopardising the use of trade as a tool for growth and the capacity for sophisticated economic interventions is limited.

7. The global context of aid: the challenges of scaling up

52. An important factor influencing the design of an effective aid-for-trade initiative is the overall aid context in which it will be delivered. If donor commitments are met, ODA is expected to reach about USD 130 billion by 2010, an increase of USD 50 billion from 2004 and twice the amount spent in 2000. The challenges for partner countries of managing such a scaling up of aid inflows are numerous. They include; (1) maintaining a stable macroeconomic framework with an increasing share of the economy -and particularly budgetary resources financed by multiple and volatile sources of external assistance; and (2) improving public financial management while facing increasing disincentives to mobilise domestic resources and rationalise expenditure. In terms of the effectiveness of aid-for-trade, two issues seem particularly relevant: absorption capacity constraints and the potential for a Dutch disease syndrome.

7.1 *Absorption capacity*

53. Absorptive capacity constraints are influenced by the macroeconomic impacts of aid on the fiscal and external deficits and by the capacity of the government to deliver services, select projects, exercise financial control and manage them effectively to satisfy expectations. Many partner countries are in fact already experiencing absorption capacity constraints. Most studies on the relationship between aid and growth show diminishing returns after aid has reached a certain level of GDP. Estimates on the saturation point – the level of aid after which it ceases to have a positive effect on economic growth – vary significantly across countries within a range of 5% to 25% of GDP depending on the quality of institutions (Collier and Dollar, 2002).

54. Considering that aid to a number of African countries is already above 10% of GDP, the proposed scaling up of aid will have to be carefully sequenced to ensure that the absorptive capacity of countries is one step ahead of the committed funds. As Heller (2005) highlights the sequencing of reforms becomes critical. Certain initial human capital and infrastructural bottlenecks must be tackled if adverse effects from scaling up are to be minimized. Given the wide scope of the broad aid-for-trade agenda, it is likely that any substantial increase in assistance will affect capacity constraints and thus, the effectiveness of the whole scaling up exercise. Indeed, while aid-for-trade could play a critical role in increasing absorptive capacity through technical assistance and capacity building, economic infrastructure and boosting productivity, the complexities of the agenda and linkages with the domestic economy might also absorb too much capacity, impose the wrong sequencing and undermine other priorities. It is thus crucial that aid-for-trade is fully coordinated with other aid flows. The obvious tool to coordinate all aid flows are National Development Strategies (PRSs, CAPs).

7.2 *Dutch disease*

55. The expected scaling up of aid has renewed concerns about the potential of aid flows to create a real appreciation of the aid recipient's currency – the “Dutch disease” effect – and thereby dampen the export competitiveness of a country. A recent study by Rajan and Subramanian (2005) finds that aid had systematic adverse effects on countries' competitiveness, as reflected in a declining share of labour intensive and tradable industries in their manufacturing sector as a result of real exchange rate appreciation caused by aid inflows.

56. Inflows of aid, *i.e.* foreign currency, increase the demand—both for tradables (items that are readily exported or imported, such as consumer goods) and non-tradables (items that are not readily exported or imported, such as housing). In theory, greater demand for tradables should be easily satisfied through an increase in imports. But higher demand for non-tradables could encounter production bottlenecks leading to pressures for higher wages and other inputs resulting in a rise of their price relative to tradables, thus pushing up the real exchange rate. This leads to a loss of competitiveness and lower growth of the tradable sector.

57. Real exchange rates effects on export growth can be significant. In the context of trade policy reforms, this means that the reduction in trade restrictions is not accompanied by a depreciation as large as would otherwise be necessary to trigger a rise in exports; thus, prices for import substitutes fall more. This inflicts pain on producers of import substitutes early in the reform program and reduces the incentives for exporters. It defers the export supply response and worsens the political economy of trade reform. Moreover, recent studies find that growth accelerations are associated with currency depreciation suggesting that a large appreciation associated with scaling-up could have long term growth costs (Hausman, Pritchett and Rodrik, 2004).

58. From a development perspective, the benefits of aid in reducing poverty and building long-term competitiveness can often offset the costs of reduced competitiveness in the medium term. However, it is clear that the effectiveness of an aid-for-trade initiative would be seriously undermined if the additional aid contributed to reducing the recipient country's export competitiveness.

59. There are various strategies available to governments to sterilise this effect for example by building up foreign reserves, but these imply not spending or at least deferring into the future the disbursement of additional resources. The other strategy to mitigate negative exchange rate effects is to ensure that aid does deliver higher productivity, particularly in the non-tradable sector - such as roads, storage, ports, distribution - that enables the sector to expand supply instead of increasing prices. A key role of aid-for-trade assistance is to tackle the bottlenecks hampering supply and productivity in the non-tradable sector. In particular, support to inter-regional trade, through improvements of regional trade infrastructure or reduction in other trade barriers, might have a key role in increasing the productivity of the non-tradable sectors. Increasing productivity in the tradable sector might help the sector to cope with an appreciation of the real exchange rate but will not mitigate the appreciation effect. Significant additional aid flows, including for trade-related activities, might undermine a recipient country's export competitiveness if it fails to lift the productivity of the non-tradable sector.

8 An Aid-for-Trade Partnership

60. In conclusion, increasing the effectiveness of aid-for-trade assistance is absolutely crucial to counteract the negative effects of aid flows on export competitiveness, and aid effectiveness principles of the Paris declaration are fully relevant to this agenda. At the same time, exhortations to increase aid-for-trade flows and aid effectiveness alone will not contribute to success or to enhancing the credibility of donors' commitments to this agenda. The inclusion of aid-for-trade in the Hong Kong declaration and the creation of a WTO Taskforce offer the aid and trade community the opportunity to establish a framework for aid-for-trade assistance which provides incentives to recipients and donors alike to:

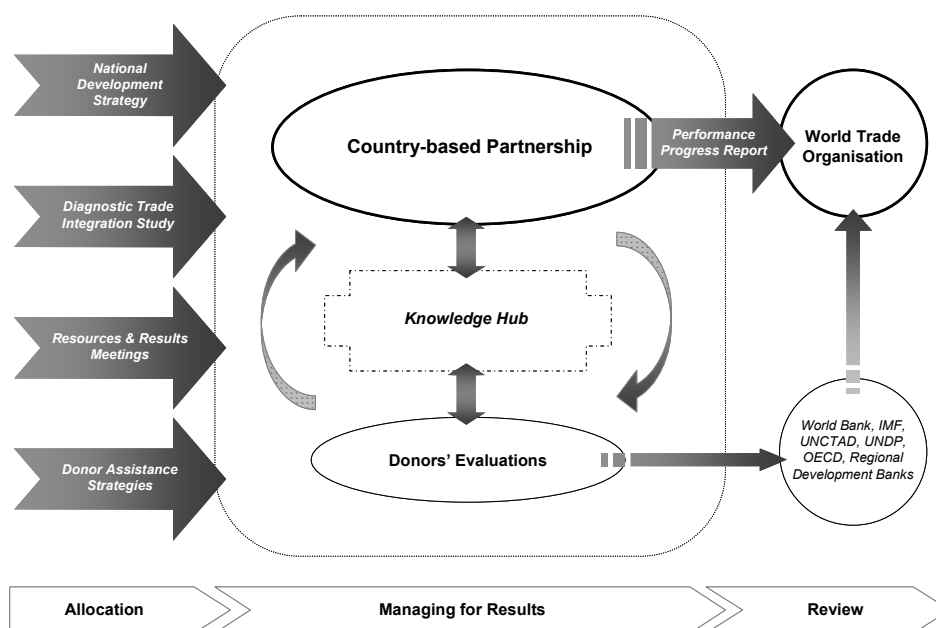
- Foster the complementarities and synergies between trade and other economic policy areas;
- Strengthen country ownership, align around country strategies and harmonise donor procedures;
- Enhance the credibility of donors' commitment to increasing aid-for-trade;
- Improve co-ordination and coherence of aid-for-trade with overall aid strategies;
- Support knowledge management and improve technical capacity in recipient and donor countries, and;
- Enhance management for results and mutual accountability.

61. Some commentators, such as Zedillo (2005), Stiglitz and Charlton (2006), have advocated the creation of a Global Facility for Trade. They suggest that such a vertical aid-for-trade fund should consolidate all existing multilateral categories of aid-for-trade and be mandated to finance technical assistance, trade related capacity building, enterprise development, and infrastructure projects through a combination of grants and concessional loans. Specific vertical funds can be useful to channel financial resources to specific needs that are relatively neglected in overall donor programmes or which can be easily delinked from the broad national development strategies.

62. However, the characteristics of the aid-for-trade agenda do not satisfy these criteria and, consequently, the effectiveness of aid-for-trade would be undermined by the creation of a Global Aid-for-Trade Facility. First of all, it is impossible and undesirable to separate the trade-related agenda from the economic growth agenda. A key tool to ensure that recipient countries benefit from integration in the world economy is to build trade capacities, strengthen supply side responses, including through improved infrastructure. Prioritisation of these capacities gaps and needs can only be done effectively and efficiently when trade is mainstreamed into national development strategies. Second, a broad interpretation of aid-for-trade represents around a quarter of net ODA, and there are strong signs that donors' renewed interest in this agenda will result in additional ODA for it. Against that background, aid for trade should be fully integrated into the strategies that are being developed by the IFIs, the UN Agencies and the OECD/DAC, to support the scaling up process at the country level through partnership meetings focussing on resources and results (OECD, 2006b). Finally, the prospects of this significant scaling up of aid and related risks of losing export competitiveness through 'Dutch disease' further underlines the need to mainstream aid-for-trade into the broader development assistance system.

63. In short, it is highly unlikely that aid-for-trade would be effective if the financing and allocative mechanisms are not strongly embedded in the existing national development strategies (*e.g.* PRSS) around which and donor can align their assistance strategies programmes. While there are no compelling reasons to create new institutional mechanisms for the financing and allocation of aid-for-trade, there is a very clear need to strengthen the evaluation, monitoring and review processes and to increase both donors and recipients accountability and transparency of the assistance provided and the results obtained. Different mechanisms could be suggested to achieve these objectives. The figure below shows the key elements that an aid-for-trade framework would ideally include. The top priority should be to establish a formal country-based, cross-ministerial, monitoring and evaluation mechanism. This would increase the accountability of donors in terms of the financial resources provided and joint accountability for results. A partnership involving all country-based aid-for-trade practitioners would provide incentives and means to foster country ownership, donor alignment and harmonization. An obligation to report regularly the results of the assistance should also help to focus minds on prioritizing management for results.

Figure 4. A Partnership Framework to Promote and Monitor Aid-for-Trade



64. More traditional evaluations of individual and multilateral donors' strategies are important to ensure the dissemination of best practice across countries, identify areas for improvement and increase transparency on pledges and commitments. The joint OECD-WTO data base already monitors financial commitments in the area of TRTA/CB, while the DAC database provide financial information on donor support for infrastructure and building productive capacity. The database could be complemented with qualitative information and assessments based on the results obtained by different donors. Another possibility is to mandate all the multilateral and bilateral donors active in aid-for-trade to report annually or biannually to the WTO on results obtained.

65. Indeed, the WTO seems the best forum to review on a regular basis whether aid-for-trade is being adequately funded and is delivering the expected results. The WTO has a vested interest in ensuring that all its members benefit from trade and WTO agreements. It is a consensus based organization where developing and developed countries have equal weight. And, it has institutional experience in reviewing complex policy areas through its Trade Policy Review Mechanism. Although, it does not have country presence and little hands-on experience with providing aid (except for technical assistance) this would not be a problem, if its role was confined to reviewing country-based performance progress reports and donors' evaluations with the view to formulate recommendations and disseminate results.

66. Using aid to remove the policy and structural impediments to export competitiveness is a challenging task, both for donor and recipient countries. It requires first and foremost enhancing the technical knowledge and capacity of donors and recipient countries. This seem to calls for the introduction of a less formal mechanism dedicated to exchanging ideas, information and lessons of experience and building-up a knowledge hub of best practises and recommendations. These functions are at the heart of the OECD mission; the OECD has built up a wide range of experience in supporting the creation, flow and dissemination of ideas and best practices, and it could be a natural partner to efforts aimed at establishing such an informal mechanism. For example, the Partnership in Statistics for Development in the 21st Century (PARIS21) initiative² (which is housed in the OECD) offers an interesting template for developing a knowledge hub for aid-for-trade practitioners. PARIS21 is aimed at disseminating evidence-based policymaking. It develops guidelines, best practices, and reporting methods to monitor the progress in strategy implementation made at country level. This type of approach might be conducive to creating a forum in which aid-for-trade practitioners from developed and developing countries would discuss their experiences and work jointly to develop trade capacity tools and monitor progress, free from the usual constraints present in forums dominated by donor-recipient relationships. It will also provide a much needed opportunity for developing countries practitioners to learn from other developing countries' experiences.

2. For further information see <http://www.paris21.org/>

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