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FREE TRADE OR FAIR TRADE?

An enquiry into the causes of failure in recent trade negotiations

Mehdi Shafaeddin

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DISCUSSION PAPERS

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Abstract

Trade policy is at a crossroads. So is trade diplomacy. The failure of the "traditional import substitution" policies of the 1950s–1970s has been followed by the failure of trade liberalization in the 1980s and 1990s by developing countries. In particular, the deadlock in the negotiations during the recent meetings of WTO has demonstrated the severe differences among various groups of member countries. Focusing on frictions between developing countries and industrial economies in the particular area of trade in manufactured goods, the purpose of this paper is to argue that the failure of the negotiations is related to a number of fallacies and contradictions surrounding the concepts and practices of universal trade liberalization and infant industry protection. These main fallacies include: the philosophy behind universal and across-the-board trade liberalization; the contradictions in the design and implementation of GATT/WTO rules to the detrimental interest of developing countries; the theory and practice of infant industry protection; and, in particular, perceptions about the interests of developed countries in universal and across-the-board trade liberalization by developing countries.

Emphasizing that free trade should be the ultimate aim of every nation once all economies have reached the same level of development, it is argued that there is a need for revision of international trade rules. In the design of the new rules more attention should be paid to the level of development and industrial capacity of developing countries. Developing countries should have a clear trade and industrial policy as well as negotiating strategy before entering the negotiation. To play such a proactive role, along the lines suggested in the UNCTAD "Positive Agenda", developing countries should: link their trade policy to their development objective; and follow a dynamic trade policy geared to their level of development, industrial capacity, structural characteristics and changes in the world economy, as suggested by Shafaeddin (1995). Moreover, in their common negotiation strategy, instead of agreeing on a "least common denominator", they should attempt to cooperate en elaborating a strategy aiming at the trading rules that differentiate countries, in accordance with some agreed criteria. Such criteria may include a number of indicators, such as per capita income, the degree of dependence on primary commodities, the share of manufacturing in GDP, etc.

Finally, it is a myth to believe that concessions will always be made to developing countries on "moral grounds". "Bargaining" is the name of the game. Developing countries should mobilize and make the best use of whatever bargaining chips they possess, however small they may be; and developing countries can have some leverage in trade negotiations if they mobilize (Shafaeddin, 1984). Bargaining requires not only bargaining assets, but also knowledge, information about the issues concerned, and training for undertaking trade negotiations. In such a context, at the country level there is a need not only for policy formulation and for strengthening the capacity of commercial diplomacy to enhance bargaining skills, but also for strengthening the capacity for trade and industrial policy formulation.

I. INTRODUCTION

Trade policy is currently at a crossroads, as is trade diplomacy. The failure of the "traditional import substitution" policies of the 1950s–1970s has been followed by the failure of trade liberalization by the developing countries in the 1980s and 1990s . In particular, the deadlock in negotiations during the recent meetings of the World Trade Organization (WTO) has demonstrated the severe differences among various groups of member countries on such issues as universal and across-the-board trade liberalization, movements of capital, etc. The emergence of the deadlock raises some questions about the reasons for such profound differences of view. Without a thorough understanding of these differences and conflicts of interests among the various groups involved, a successful outcome to the negotiations can only be limited.

As far as trade liberalization is concerned, the purpose of this paper is to show that the failure of the negotiations is related to a number of fallacies and contradictions surrounding the concepts and practices of universal trade liberalization and protection. The main fallacies are related to: (i) the philosophy behind universal and across-the-board trade liberalization; (ii) contradictions in the design and implementation of agreed rules during the various rounds of trade negotiations under GATT and in the positions of some groups in their implementation; (iii) the theory of protection of infant industry; (iv) and, in particular, perceptions about the interests of developed countries in universal and across-the-board trade liberalization.

Section II summarizes the recent events since the conclusion of the Uruguay Round Agreement (URA). Section III refers to the fallacies in the philosophy behind universal trade liberalization and to the limited explanatory power of the related theory, i.e. the theory of static comparative advantage (CA). Section IV is devoted to the discussion of fallacies surrounding the theory of protection and the infant industry argument. Contradictions in the design and implementation of trade liberalization agreements will be examined in section V. In section VI arguments will be put forward that universal, across-the-board and premature trade liberalization is not only against the interest of developing countries, but more importantly, is against those of developed countries too. The final section will present some conclusions outlining policy implications and present some recommendations.

It should be emphasized from the outset that, as will be explained later in this paper, free trade should be the ultimate aim of every nation once all economies have reached the same level of development. Hence, the content of this study should not be interpreted as expressing views against that "ultimate" aim.

II. SUMMARY OF EVENTS

The URA was negotiated and signed in a period during which the Group of 77 was in disarray, stricken by debt obligations and the impact of changes in the former Soviet Union and the end of the cold war in world politics. Moreover, developing countries were not, according to the Secretary-General of UNCTAD, technically prepared for the negotiations while they lacked their own trade objectives and adequate strategies

(UNCTAD, 1997: 1–8). They were influenced, either ideologically or under pressure, by the dominant views of the time on the advantages of universal trade liberalization.

A number of factors, however, have caused the governments of many developing countries, as well as citizens of both developed and developing countries, to have second thoughts on the merits of fast, universal and across-the-board trade liberalization. One of these factors is the development of the balance-of-payment crisis in East Asia – which had the most successful economies of the 1980s and early 1990s – and in Brazil, which led to financial and economic crises not only in these countries but also in the world economy as a whole. Some severe balance-of-payment crises also emerged in other developing countries. The second factor was the failure of fast and across-the-board trade liberalization in a large number of least developing and other low-income countries, particularly in Africa, which are characterized by a low level of industrial capacity, to diversify into manufacturing exports. The third factor was the change in the industrial structure in many developing countries, particularly in Latin America, in favour of specialization in resource-based industries and against labour-intensive industries, thus delaying development of industries in which these countries could attain dynamic CA (Benavente et al., 1999). Moreover, a concentration emerged of manufacturing production in favour of large enterprises, both domestic and foreign-owned, and against small- and medium-sized enterprises, with a consequential impact on the level of employment and income distribution. Fourth, generally speaking, recent trade liberalization has been accompanied by worsening income distribution not only within developing countries, but also within developed ones and between developed and developing countries (UNCTAD, 1998 and UNDP, 1999, chap. 1). Fifth, the emerging financial and economic crises in developing countries led to a global financial crisis threatening the stability of the world economy. In other words, the crisis had led to a higher degree of instability (risks) at a lower level of output and employment in the world economy, with the notable exception of the case of the United States. That country was less affected by the crisis owing to a relatively low share of trade in its GDP, the domestic expansionist policies of the Federal Reserve System and the compensatory impact of the technological revolution, which created jobs and demand for investment. However, the impact of the world financial crisis on the United States manifested itself in the magnitude of the country's balance-of-payment deficits and in the cost to the tax payers of the bailout of the crisis-stricken countries.

Finally, developing countries felt that they had made a greater commitment to liberalize trade than had developed countries, through URAs and Structural Adjustment Programmes and Stabilization Programmes. They also felt that implementation of the commitments made under URAs by developed countries had been slow and unsatisfactory.

The reflection of these developments on the process of trade negotiations demonstrated itself in a series of problems and deadlocks in agreements on issues discussed in WTO. In the first place, the appointment

of the Director-General of WTO became the subject of intensive negotiation and disagreement between developed and developing countries. Subsequently, the member countries could not agree on the draft agenda on the new round of trade negotiations for consideration by the Ministers at Seattle. More importantly, even in Seattle, no agreement was reached on the agenda. The meeting took place in the midst of street demonstrations, which were regarded by the press as unprecedented since those against the Viet Nam war. Various groups, both from developed and developing countries – labour organizations, environmentalists, NGOs, human rights activists, etc. – showed their dissatisfaction with the course of events regarding trade liberalization and globalization. Notably missing in the list of demonstrators, however, were representatives of TNCs and large businesses.[1]

Since then various views have been expressed on the impact of the failure of the Seattle meeting on the future of trade negotiations, free trade and globalization. For example, Peter Kenan, a widely respected economist at the University of Pennsylvania, believes that: "The grime message of Seattle is that not only we won't have a new round now, but we won't have one for some time …" (*International Herald Tribune*, 9 December 1999: 4). Jeffrey Garten, another distinguished scholar at Yale University, stated that: "There's been a real democratization of the debate over trade and globalization … What Seattle showed was that there is a lot more angst beneath the surface" (loc. cit.). A former Canadian trade negotiator was more pessimistic expressing his feeling that: "I don't know if the WTO system can survive. It is badly weakened right now" (loc. cit.). According to Julius Katz, Deputy Trade Negotiator in the former President Bush Administration: "Things are going to just limp along until there can be wholesale rethinking of the trade strategy" (loc. cit.).

What is wrong with the present trade strategy for it to require new thinking? While opinion might differ on this issue, it is the intention in this study to show that, as far as developing countries are concerned, the answer is related to the fallacies surrounding the theory and practice of trade liberalization. In fact, these fallacies and contradictions are the reason for developed and developing countries remaining far apart. According to Charlene Barshefsky, the US Trade Representative: "The developing world is not hearing what we are saying and we're not hearing what developing world is saying. We're passing like ships in the night" (K. Engelmann, *Reuters*, Yahoo Internet site, 20 January 2000). This study aims at shedding some light on the reasons for such misunderstanding.

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[1] It seems that the story does not end at Seattle. There were further demonstrations at Davos during the meeting of the World Economic Forum in objection to trade liberalization and globalization. Similar demonstrations took place during the joint meetings of IMF and the World Bank in April (*International Herald Tribune*, 27 January 2000: 17; *Wall Street Journal*, 6 April 2000: 1 and 12), as these institutions were perceived to have also been behind trade liberalization through Structural Adjustment Programmes and Stabilization Programmes. More recently, demonstrations took place in Sydney, prior to the opening of the Olympic games and in Prague during the joint meetings of IMF and the World Bank.

III. FALLACIES IN THE PHILOSOPHY BEHIND UNIVERSAL TRADE LIBERALIZATION

It should be mentioned from the outset that the focus of the argument in the rest of this study is on the manufacturing sector, although occasionally reference is also made to services and agriculture.

As it is currently viewed, the philosophy behind trade liberalization suffers from some fallacies. The current perception of trade liberalization involves two pillars: "universality" and "uniformity". Universality implies that free trade is to the benefit of all countries irrespective of their level of development, industrial capacity, technological capabilities and other structural characteristics. Uniformity implies that for each country all industries and products should be subject to the same level of tariffs – ideally zero tariff rates.

A. The foundation of theory of trade liberalization

The foundation of the theory of universal trade liberalization consists of two main and interrelated elements: the static version of the doctrine of CA and the implicit premiss that markets always function well.[2]

According to the theory of CA, in a simplified two-country, two-commodity model, given tastes and demand conditions, the pattern of specialization and comparative cost advantage are (in the Ricardo version) influenced by the differences in labour productivity (the *quality* of the factor of production), or by differences in factor endowment (the *quantity*[3] of factors of production in the Heckscher-Ohlian [H-O] version).[4] In other words, each country will specialize in the production and export of those commodities that intensively employ the factor of production which is, relatively speaking, the most abundant in the country. Despite differences between the Ricardo and the H-O versions concerning the source of CA, in both versions each country allocates its resources on the basis of the present structure of costs. In other words, CA is market determined; and (free) trade improves efficiency of resource allocation in both countries; a shift in the production possibility curve is neglected, i.e. long-run capacity-building is not considered. Some followers of the classical theory do not neglect dynamic consideration, but they assume that those considerations are reflected in current costs and prices. According to this theory, developing countries should specialize in the production and export of those labour-intensive products and/or agricultural goods and other primary products (if one considers natural products as another factor of production) which are their most abundant factor of production.

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[2] According to Krueger (1980: 289): "… markets would function well and provide growth if only policy makers would abstain from unproductive intervention". The doctrine of CA is implicit in the theory of universal and across-the-board trade liberalization, even though some lip-service is paid to consideration of the dynamics, i.e. the infant industry argument.

[3] See Viner (1953: 15) for this distinction.

[4] In the Ricardo version of the theory of CA, production technology for a product differs from one country to another, but the factor endowment remains the same. In the H-O version, technologies of production vary between commodities in each country, but are the same for any particular product in both exporting and importing countries.

One implication of the H-O version of the doctrine of comparative cost advantage is that, since firms play no active role, CA is achieved at the level of the national economy. Hence, present market-determined factor costs (wages, interest rates, and raw materials) are the only source of international competitiveness. Since the exchange rate converts national prices into international prices, it is influential in attaining international competitiveness. By contrast, neither productivity[5] nor non-price factors play any role in international competitiveness. Another implication concerns the terms of trade, which are established by the forces of reciprocal supply and demand for exports and imports, and are not influenced by power relations in international trade.

The doctrine of CA suffers from two main deficiencies: its restrictive and unrealistic assumptions, and its limited explanatory power.

B. Unrealistic assumptions

The theory of static CA is based on a number of unrealistic assumptions. As one of the proponents of free trade has emphasized: "Theory does not say – as is often asserted by the ill-informed or wrongly taught – that 'free trade is best'. It says that, given *certain assumptions* [original italics] it is best" (Corden, 1974: 7–8). In fact, Paul Samuelson, one of the founders of the modern theory of international trade, goes further to warn "against a possible misinterpretation of the classical theory [of international trade]" (Samuelson, 1938: 266), which is the basis of the neoclassical theory. According to him, first of all the theorem says that free trade, or some trade, is better than no trade (autarky) but does not necessarily imply that free trade is the optimum for any country (op. cit.). In a two country model "under free trade both parties are better off[6] than under no trade at all, but are not necessarily in the optimum position … The free trade equilibrium point very obviously is not the most preferred point to any one country" (ibid.: 265). He further emphasizes that "it is not possible to demonstrate rigorously that *free* trade is better (in some sense) for a country than *all* other kinds of trade" (Samuelson, 1939: 195), and that "it is not necessarily true that free trade is the best trading policy" (ibid.: 203).

Secondly, he clearly mentions that even these results are based on abstract assumptions: "… much more important than the carrying through of the formal steps of the argument [in applying general equilibrium theory to international trade] is the realization that the theorems are true consequences of the premises, and do not rest on *presumptions or probability*. For in pointing out the consequence of a set of abstract assumptions, one need not be committed unduly as to the relation between reality and these assumptions"

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[5] The trade liberalization hypothesis advocates that export promotion leads to productivity improvement, as mentioned earlier. It neglects, however, the role of the many different factors which contribute to productivity improvement at both the micro and macro levels.

[6] Meaning that they can increase their consumption with the same (or less) productive resources, or that they can consume the same amount of goods while using less productive resources.

(ibid.: 205). He refers explicitly to some of those assumptions which serve the foundation of the general equilibrium theory and the modern theory of international trade:

(i) If the laws of return were appropriate for perfect competition (no external effects, indivisibilities, monopolies, dynamic uncertainties, learning processes, etc.), free trade and ideal transfers could be used to give maximal global production, in the sense of the farthest outward production possibility frontier;

(ii) Free trade and ideal transfers could give a similar maximal world utility frontier for all individuals;

(iii) Free trade will not necessarily maximize the real income or consumption and utility possibilities of any one country – even though by ideal bribes the international winning countries could bribe the losers into a unanimous vote for tree trade.

(iv) For a given country, autarky cannot be optimal if ideal transfers are possible. Some trade is better than no trade in the sense of making the nation better off, with a farther out consumption-possibility frontier and farther out utility-possibility frontier (Samuelson, 1962: 829).

The H-O theory, in a simplified two-factor, two-commodity, two-country model (let us assume that one country is a developing country or group of developing countries, and the other is a developed country or group of developed countries), contains the following assumptions:

(i) Perfect competition and constant return to scale;

(ii) Full employment of resources;

(iii) Countries are similar in all respects except for factor endowments;

(iv) The two commodities show different factor intensities and use different technologies, but each product is produced with the same technique in both countries;

(v) The technological know-how is costless, and is freely available to both countries.

According to the first assumption, perfect competition prevails in both commodity and factor markets, and markets are free and complete and function well. The market is complete in the sense that both present and future markets exist for all goods and factors of production, the set prices of which are determined in Walrasian general equilibrium. The assumption of perfect competition is in turn characterized by a set of assumptions which are not all necessarily explicitly included in relevant writings on international trade. The most important of these assumptions are directly, or indirectly, related to the size of the firms and include: the atomistic nature of market – i.e. the small size of all firms involved in the market; constant return to scale, which implies that as inputs increase by a certain proportion, output increases by the same proportion; passivity of firms and absence of power in the market; free entry to and exit from the market; availability of perfect information on supply and demand, and on prices for all products and factors of production; homogeneity of goods and factors of production; lack of uncertainty and risk; given resources and technology; and lack of intertemporal relations, i.e. independence of present costs and prices and future (or

past) costs and prices. Moreover, it is assumed that economic institutions and organizations are given and are conducive to the operation of market forces.[7]

Assumption (ii) is clear; assumption (iii) would imply that all countries are similar in terms of level of development, industrialization, technological capacity, taste, infrastructure, institutions, organizations, etc.; assumption (iv) is implicit in assumption (iii); assumption (v) implies that no firm has monopoly over technology and that patents do not exist.

In addition, the theory of CA is also based on the assumption of the perfect functioning of markets elsewhere – i.e. not only in the country concerned but also in the importing countries – and on the absence of political influence in the flow of international trade and international harmony of interests – i.e. cosmopolitanism (Panic, 1988, chap. 7). Moreover, it is assumed that factors of production[8] are homogenous and mobile within each country, but immobile between countries. Trade does not involve transport costs and sales are not targeted at a particular market.

Most of the assumptions outlined above are unrealistic. We do not intend to review them in detail as the literature on the issue is vast. Nevertheless, let us refer briefly to some of the most important ones which have implications for our argument. These are perfect competition, constant return to scale, similarities of countries, full employment and the absence of uncertainty and risk.

C. Perfect competition and constant return to scale

The assumption of perfect competition and well functioning of the market is not realistic, particularly in the case of developing countries. First and foremost, the market for main manufactured goods is not atomistic and the firms involved are not passive. In each industry, the international market is dominated by a few large – in fact mega – global firms. The assets of the largest 100 TNCs amounted to $4.2 trillion in 1997; moreover, the top 25 of which accounted for about half of the assets of these firms, and the largest five together owned a quarter of their total assets (table 1). To put the magnitude of activities of these companies into perspective, the sales of some of them exceed the GDP of some middle-income developing countries. For example, in 1997 the sales of General Motors exceeded the GDP of Norway and Thailand, those of Ford Motors and Mitsui each exceeded the GDP of Saudi Arabia; while the sales of Sumitomo, Exxon (before merging with Mobile), Toyota Motors and Wal Mart Stores each exceeded the GDP of Colombia, Israel, Malaysia, the Philippines and Venezuela (UNDP, 1999, table 1.1). As shown in table 1, such mega companies are present in all industries; they have developed over time through expansion or

[7] For more details on some of these assumptions see Haberler (1950) and Panic (1988).

[8] In the Ricardo version, labour is the only factor of production, while in the H-O version there are two factors of production: labour and capital.

Table 1

Some indicators of the top 100 TNCs, 1997

Industry	*No.*
Chemicals and pharmaceuticals[a]	21
Electronics/electrical equipment	18
Automotive	14
Petroleum refining/distribution and mining	13
Food and beverages[b]	9
Diversified	7
Telecommunications/utilities	4
Trading	3
Machinery and engineering	2
Metals	-
Construction	3
Media	1
Others	5
Total (No.)	100
Total assets ($ billion)	4,212
Share of the largest 25 (%)	48.1
Share of the largest 10 (%)	32.6
Share of the largest 5 (%)	24.2

Source: Based on UNCTAD (1999a, tables 111–1, 111–3 and 111.5).

a Chemicals also include Montedison.

b Includes also British American Tobacco, Phillip Morris and McDonald.

mergers and acquisitions (M&A), which have become increasingly common in the last couple of years. According to the *Economist*, the "1000 largest companies account for four-fifths of the world industrial output" (*International Herald Tribune*, 20–30 January, 2000: 6).

The emergence and development of mega firms has an important economic reason with its significant implications for the international trade of developing countries. The rationale for mergers is basically economies of scale at the firm level. More recently, the production process in both industrial and services sector is becoming more and more knowledge-based. Thus, R&D and technological progress have become

more important. Moreover, the importance of brand names, and marketing and advertisement in the cost structure has increased. All these activities, particularly R&D, involve significant economies of scale internal to the firm; so does financing, as larger firms can borrow at lower interest rates. This should not imply that economies of scale in production are no longer important. On the contrary, "Most high-tech companies have both knowledge-based operations and bulk-processing operations" (Arthur, 1996: 103). What it means is that the relative importance of know-how, R&D and marketing in the production and distribution process has increased, as has the importance of internal economies of scale at the firm level. The mergers between such companies as GM and SAB, Ford and Volvo, and Daimler and Chrysler may be seen in this light.

Contrary to the doctrine of CA, technology and know-how are neither costless nor do they move freely from one country, or firm, to another; their development is costly and risky, and once developed they are patented. Hence, those companies enjoying economies of scale in R&D are placed on the frontiers of technology. These are large and established companies of developed countries which are neither passive nor producers of homogenous products. Increasing return to scale provide them not only with market power and cost advantage, but more importantly with the "power of creative destruction".

Such power provides them with the ability to adapt constantly to new situations by developing new technologies, new products and processes, placing them on a competitive edge in the international market. In such a process, increasing return generate instability and constant "competitive disequilibrium" – and not competitive equilibrium, as envisaged in the theory of perfect competition and doctrine of CA (Young, 1928). It leads to dynamic competition and cumulative causation, in the process of which firms are active and become the driving force in international trade.

To explain in more detail, the competitive advantage of firms is based on two elements: cost factors, and other factors such as the ability to develop and design new products and processes, product differential, time delivery, etc. Economies of scale at the plant and firm levels (per period of time) are one source of cost advantage, but not the only one; hence, per se they may not necessarily provide cost advantage. Absolute cost advantage may also result from patented production methods, entrepreneurship and favourable access to cheap inputs. Economies of scope and learning-by-doing – that is, experience – are another source of cost advantage. Learning-by-doing is a function of time and the amount of cumulative output (Scherer and Ross, 1990, chap. 10; Sawyer, 1991, chap. 4).

Product differential can provide a small- or medium-sized firm with a market niche, as does location in a particular market. Similarly, when an industry – e.g. a semi-conductor industry – is subject to rapid technological change, "the development of a completely new design often permits an initially handicapped producer to jump to a new learning curve in a position of equality or even superiority" (Scherer and Ross, 1990).

Available evidence indicates that all the factors outlined above are important sources of cost and competitive advantage, but the empirical results are not always conclusive about the relative importance of each. Nevertheless, on the whole the established and large firms have by and large more advantage in relation to young and small firms in developing countries. Apart from economies of scale, they are often better

equipped, for example, to take advantage of product differential, and their scale of production contributes to learning-by-doing over time through its contribution to accumulated output. Similarly, large established companies are usually better placed to enjoy economies of scope. Consequently, they can create barriers to the entry of new firms – thus increasing their risk of success. More recently, economies related to globalization, particularly those resulting from networking and strategic alliance, have been providing another source of cost and competitive advantage for established firms (for more details see UNCTAD, 2000).

One implication of increasing return to scale (internal to a firm) is thus to destroy the foundation of the doctrine of CA and, therefore, nullify the recommendation to all countries to adopt free trade. The cost which decreases with the scale of production is not the same as that determined by the abundance of resources. The sources of the two costs are different. Moreover, every move made affects not only the structure of current costs and prices, but also the structure of future costs and prices. Also, every decision by one firm affects the position of other firms. Contrary to CA doctrine, there is intertemporal interdependence of decision and interdependence of action between firms. In this sense, past or present decisions made by businesses in developed countries will affect the current or future competitive position of those in developing countries. Any established firm which enjoys increasing return creates additional markets for the products of other firms, thereby contributing to a reduction in their cost through created externalities.

In this sense, trade is important in providing markets, as well as greater specialization and division of labour; but it is the result of a dynamic process of disequilibria – not a tendency towards a "competitive equilibrium" (for details see Streeten, 1990). In the language of Porter (1990), it is the result of the "competitive advantage" of firms.

If this is the case, those developed countries which first started the process of industrialization have gained from the increasing return, division of labour and experience, and developed "competitive advantage", particularly in certain lines of production-manufactured goods. Further, through their know-how and technology they can now reap the fruit of "competitive advantage". This analysis is not purely theoretical. As will be explained below, in fact empirical evidence also shows that the explanatory power of the CA doctrine is limited.

D. Full employment and similarities between countries

The theory of CA assumes that resources are fixed and fully employed and that all countries are similar, i.e. are at the same stage of development, industrialization and technological development. Therefore, when a country enters into international trade, resources will be reallocated in such a way that the increase in production of one product (e.g. exports) will be at the cost of reduction in production of another product (e.g. production for the domestic market); in practice, this is not the case. Developing countries, particularly those at an early stage of development, have a reserve army of labour which cannot be absorbed productively by the agricultural and/or mining sector. The lower the level of development, the higher this reserve – called "unproductive labour" by Adam Smith. This labour reserve provides the country with surplus (productive)

capacity – "surplus over domestic requirement". In the nineteenth century, some surplus labour was transferred from subsistence agriculture to plantations and mining for exports, thus increasing the economy's overall productivity. So exports increased without a reduction in domestic consumption, and provided resources for imports of additional goods which would not have been otherwise available to the country. In other words, the expansion of exports was not the result of reallocation of resources, but was due to the allocation of surplus resources (labour and land) to additional output in the newly established plantations and/or newly discovered mines (Myint, 1958).

Nevertheless, this development involved serious limitations in absorbing fully the reserve of surplus labour. As a large number of countries have gone through the same process, the possibility of allocation of surplus productive capacity to mining and plantations has become limited as a result of limitations in the expansion of external demand and/or limited land and mine reserves (Myint, 1958). Hence, the development of other activities, including manufacturing industries, is required to absorb the productive capacity of surplus labour. This argument applies so long as the economy is not fully employed (ibid.). However, the static version of the doctrine of CA does not explain how an economy which has specialized in primary commodities might develop productive capacity in manufactured goods.

As far as employment is concerned, a related issue concerns countries which have developed some of their industries behind protective walls. In such cases, even the classical economists, who had advocated free trade in principal, recommended slow and gradual liberalization, as explained in section IV.

E. Explanatory power of the theory

The doctrine of CA explains the pattern of trade between developed countries, specialized in the production and exports of manufactured goods, and developing countries, specialized in the production and exports of primary commodities. It does not explain, however, the bulk of international trade, i.e. trade among industrialized countries which engage in trade in similar goods, manufactured products, and inter-industry trade. More importantly, it does not explain how countries such as France, Germany, Japan, the United States, and more recently the Republic of Korea and other NICs have transformed from primary producers to manufacturing exporters, capable of competition in the international market. The process of transition from one stage to another cannot be explained by the static nature of the theory.

Trade among developed countries is explained by increasing return to scale and/or product differentials. In theory, a distinction is made between two types of scale economies: those internal to the firm and those external it.[9] Nevertheless, the literature is not always clear with respect to the interrelation between increasing return and international trade, as the concept of increasing return is a complex one. Scale economies can be static or dynamic, they can be internal or external to an operational unit, and could be at various levels. They can be product-specific, plant-specific, firm-specific or industry-specific (Scherer and Ross, 1990: 97). One

[9] For details of the discussion see Ethier (1982).

could think of scale economies at the level of the manufacturing sector as a whole. One may also distinguish national economies from international ones at the level of industry. The sources of scale economies are also diverse; they may be not only at the production level, but also in marketing and distribution, management and control and R&D.

Let us first consider the sources of static scale economies. The source of product-specific economies is indivisibilities. Plant-specific economies have their sources in: cost savings related to "bulk transaction" for the purchase of inputs and sale of outputs; production engineering relationship; economies in keeping inventories and parts; economies of management and overhead. Firm-specific static scale economies may originate from financing, marketing and advertisement, R&D and management. Economies of scale at the plant and firm levels may also be accompanied by "economies of scope" – resulting from the production and sale of different products. The production of one line of products generates economies in the production of other lines.

Learning-by-doing and experience is an example of dynamic economies which depend on cumulative output, which is, in turn, a function of time, the size of the operational unit and the rate of growth of production. Such economies can be internal and/or external to an operational unit. Linkages among industries are examples of dynamic scale economies external to an industry.[10]

Division of labour is another source of scale economies. But the division of labour itself is influenced by the extent – the size – of a market. The division of labour may take place within a plant or firm (as in Adam Smith's example of the pin factory, in which each worker specializes in a certain task), or within an industry or industries. At the industry level, the economies of scale are national "if the average cost depends on the size of the national industry. They are international if the average cost depends on the worldwide size of the industry" (Ethier, 1988: 51).

What is considered in the literature as a base for trade is economies of scale *external* to a firm. In this case, average costs of a firm decline with the size of the whole industry, so economies are *external* to the firm; in the case of internal economies, average costs decrease with the size of the firm. As far as their implications for international trade are concerned, these economies differ in an important respect. Internal economies are inconsistent with perfect competition, thus with the doctrine of CA. By contrast, external economies (to the firm) of scale may be consistent with perfect competition. As already mentioned, a firm's costs could decline because of an increase in the size of the industry, not in the size of the firm. Individual firms are therefore still characterized by constant return to scale. A firm may be small, with no power on the market. It is argued that when scale economies (external to the firm) are national, they could by themselves be a base for trade. But in this case the pattern of trade would be indeterminate; free trade may be harmful to an individual country, and complete specialization may take place. In these circumstances, it is argued, the division of labour between developed and developing countries in the production of manufactured goods and

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[10] For more details on scale economies see Scherer and Ross (1990, chap. 4); Davis (1990: 137–138), Sawyer (1991, chap. 4) and Young (1928).

primary commodities is a historical accident which cannot be explained by the CA doctrine. Those countries or firms which were established earlier on have an advantage over newcomers.

Even if one assumes the existence of perfect competition, it should be mentioned that the argument on international external economies has been developed on the basis of Adam Smith's often neglected "productive theory of international trade" (Myint, 1958). There is interaction between the division of labour and the extent of the market over time – thus the theory is a dynamic one. As the market expands, the division of labour is facilitated, and reaping the economies of scale, at the industry level, is permitted. Thus trade is a dynamic force. By expanding the extent of the market and furthering the division of labour, trade contributes to increasing skills and innovation, and allows a country's enterprises (which may be small) to benefit more from increasing return, at the industry level.

In practice, international trade is dominated by large international companies, which enjoy substantial internal scale economies. Two points should be emphasized here. First, large firms are not passive, and their action affects the price, as well as the non-price attributes, of their products. As they produce more, they can reduce the market price. Moreover, their large size allows them to compete better on product differential and quality, and to create barriers to the entry of new enterprises and other countries. A bigger market in developed countries and their experience over time have allowed such firms to achieve internal static and dynamic economies. International trade allows even further realization of such economies.

While internal economies of scale facilitate international competition by established developed country firms, it creates barriers to developing countries. In theory, a larger international market – thus trade – should help them to reap internal economies. Nevertheless, as will be explained below, they face a dilemma because in order to enter the international market in the first place they need to become competitive. In fact, it is sometimes argued that to enter the international market developing countries should first protect their industries, so as to reap a scale of production large enough to enable them to compete in that market. In other words, the protection of industries characterized by increasing return is a prerequisite to entering the world market (Krugman, 1984).

Moreover, the distinction between internal and external economies of scale is not clear. A large firm may enjoy simultaneously both internal and external economies of scale. Consequently, there is interaction between internal and external economies. According to Young (1928), there are two interrelated aspects of division of labour: one caused by "roundabout" methods of production owing to the division of a task into small "occupations" [within a firm], the other being the division of labour among industries (external to a firm). But they interact. A firm "drives its external economies from such qualitative changes as appearance of new products, new industries …". This perception of business – shared also by Schumpeter – would imply that a firm is never in equilibrium, and competition takes place not only on price but also on non-price factors (ibid.: 528). The realization of "increasing return" is progressive and takes time. In this sense, the extent of the market is an important element of economic progress over time, as is international trade.

Hence, in both cases, whether firms are small or not, international trade is important in economic development; *thus greater openness to trade should be the ultimate aim of all countries*. Nevertheless, it is

not necessarily the immediate aim of countries at early stages of industrialization, as advocated by the doctrine of CA. With the presence of increasing return – whether internal, external, or a combination of both – the foundation of CA doctrine is shaken. *There is a dilemma for a developing country at early stage of industrialization, intending to benefit from the advantages of the extent of the market through international trade*. While entry into the international market improves productivity and competitiveness, by learning, etc., to enter the market one has to be competitive. Learning takes time, and the process of learning is specific to each industry and activity. Skills are not homogeneous, and they have to be developed in each particular industry; one cannot jump from one plateau to another without going through the learning process. Neither CA doctrine nor the theory of division of labour, as introduced by Adam Smith, provides the answer.

Some economists (like J.S. Mill, F. List and Hamilton, inter alia) have shown how this transition can take place through "infant industry" development. The fallacies surrounding such views, however, are not less numerous than those surrounding the "philosophy" behind universal trade liberalization, as explained below.

At this stage, it should be stressed again that the presence of large firms and internal economies of scale create barriers to entry into international markets. The recent process of globalization, mergers, increases in the importance of economies of scale, and changes in technology, have made entry of new- comer developing country firms into the world market more difficult. As international competition has intensified and the process of learning become more complicated, the need for support of infant industries has increased. Yet, at the same time, the possibilities for such support have become limited by changes in international trade rules.

F. Alternative views on comparative advantage

Some economists argue that, beyond the scope of agriculture and minerals, CA is arbitrary; "comparative advantage is made, not given" (Cline, 1983: 155; Amsden, 1989). In other words, when one is concerned with dynamic CA in manufacturing, "… for a broad range of manufactures the country's allocation of comparative advantage may be relatively arbitrary" (Cline, 1983: 156). A country can develop CA in an industry of its choice. Accordingly, for the development of CA the need for government intervention is implicit. In particular, rapid development, beyond what is feasible through the market forces, cannot take place automatically. According to Marshal (1920: 6), "nature does not willingly make a jump: *Natura abhorret saltum*"and "*Natura non facit saltum*" – i.e. economic evolution is gradual and continuous on each of its innumerable routes. "Economics is concerned mainly with general conditions and tendencies, and these as a rule change but slowly, and by small steps" (ibid.: 5). The market mechanism can deal with gradual and marginal changes, but it is unable in itself to accelerate development. It should be mentioned that the concept of market inadequacy is different from market failure. Even if there were no market failure, in its standard sense, the market would still be inadequate to accelerate development (Arndt, 1984). It is true that development of the market and market institutions may help its smooth operation, thus facilitating to some

extent the growth process. Nevertheless, beyond a point allowed by the market, acceleration of development and industrialization requires government intervention. The question then is not whether government intervention is required or not, but to what extent it should intervene, in what form and how the efficiency of government intervention could be improved to minimize "government failure". Examination of these issues requires another study. Nevertheless, one important point should be mentioned here. Government intervention is required to assist infant industries in new-comer countries to compete with established firms – often large – in the international market. The problem is that the theory of infant industry protection is also surrounded by fallacies and confusions.

IV. FALLACIES SURROUNDING THE THEORY OF INFANT INDUSTRY PROTECTION

The theory of infant industry protection as presented by its founders is often misinterpreted or malpresented. The literature is therefore heavily loaded with fallacies and confusions. For example, the critiques of the theory often regard the founders of infant industry protection as being opposed to free trade or even against international trade; perceive infant industry protection as being synonymous with import substitution; attribute the failure of import substitution policies, as practised by most developing countries, to deficiencies in the theory of infant industry protection; conceive "import substitution" as a permanent feature, or strategy versus export orientation strategy (e.g. Little et al., 1970; Krueger, 1978); envisage the application of infant industry protection across-the-board to the manufacturing sector as a whole, rather than on selective basis (Corden, 1974); and, finally, restrict the infant industry argument to the production stage – in fact, to production for the domestic market. As a result, not only do many scholars but also many policy makers in both developed and developing countries tend to believe that, as infant industry protection has failed, universal and across-the-board trade liberalization is the answer. The pendulum has shifted to the other extreme.

A. Infant industry protection versus import substitution (Frederick List)

Frederick List is the founder of the theory of infant industry protection,[11] and Raul Prebisch the founder of the theory of import substitution. Let us look briefly at what they actually said. To begin with, List was not by any means against international trade or in favour of autarky. He believed that international trade had an important role in economic development:

> International trade by rousing activity and energy, by the new wants it creates, by the propagation among nations of new ideas and discoveries, and by the diffusion of power, is one of the mightiest

[11] List's ideas were not all original, as he was strongly influenced by Hamilton. Nevertheless, he formulated those ideas and developed them into a theory. For more details, see Shafaeddin (2000).

> instruments of civilization, and one of the most powerful agencies in promoting national prosperity (List, 1856: 70–71).

Nevertheless, he stressed that trade is only an instrument of development. It is not an end. Moreover, he regarded "universal association" and free trade as the ultimate aim of every nation when all countries will have achieved the same level of development. While nations are in different stages of development, infant industry protection should be used as an instrument of industrialization by those who are still in the early stage of development. Over time, development would ultimately lead to universal association, allowing free trade. He argued that free trade is suitable to the advanced countries which have already established their industrial base. But for non-industrialized countries, industrialization would only be possible through free trade *if all countries were at the same level of industrialization* – an assumption made by the proponents of universal free trade.

In advocating infant industry protection for Germany, List stressed that "if the author had been an Englishman, he would probably never have entertained doubts of the fundamental principle of Adam Smith's theory. It was the conditions of his own country [Germany] which begot in him the first doubts of the infallibility of that theory …" (List, 1856: 69–70).

Secondly, in this respect, List did not consider infant industry protection to be a means of import substitution per se. *Infant industry protection would ultimately aim at massive exports of manufactured goods*. According to him, there would be four phases in the development of international trade and industrialization: (i) the expansion of imports of manufactured good; (ii) the starting up of domestic production with the help of protection; (iii) satisfaction of the domestic market; and (iv) finally the massive expansion of their exports. To expand on List, the infant industry argument does not apply only to the production stage; nor is it confined to production for the home market alone. *Production for exports also has to go through an infancy period*, which is, in fact, longer than the infancy period for production for the domestic market. This is because manufactures for export involve a chain of infancy in: production, marketing and distribution, development of brand names and reputation, technological adaptation and development, etc.

Thirdly, List did not consider protection as a permanent feature. In fact, he argued for the introduction of competition and free trade after the attainment of a certain stage of development. He advocated that protection should be temporary. After a while, pressure on protected firms should first be introduced through domestic competition in exchange for incentives provided. "Having reached the highest degree of skill, wealth and power by a *gradual return* [our italics] to the principle of free trade and free competition in their own and foreign markers, they keep their agriculture from inaction, their manufactures and their merchants from indolence, and stimulate them to wholesome activity, that they maintain the supremacy which they have acquired" (List, 1856: 188). Nevertheless, as List argued against premature and excessive protection, he also emphasized – using the example of the United States, which at a certain point attempted trade liberalization too early, therefore causing damage to its infant industries – that liberalization should not be premature and sudden, as that would ruin infant industries.

It should also be mentioned that even Adam Smith and Ricardo warned against sudden trade liberalization. "Adam Smith recognized, for instance, the possibility that a country may develop behind high protective walls 'particular manufactures' on such a scale that they 'employ a great multitude of hands' …". In such a case, Smith argues:

> Humanity may in this case require that freedom of trade should be restored only by slow gradations, and with a good deal of reserve and circumspection. The reason for this is that if "those high duties and prohibitions [were] taken away, all at once, cheaper foreign goods of the same kind might be poured so fast into the home market, as to deprive all at once many thousands of our people of their employment and means of subsistence" (Panic, 1988: 123–124) .[12]

Fourthly, List did not advocate protection of all branches of industry as was sometimes attributed to him (Corden, 1974). On the contrary, he argued for selectivity in each point in time. In fact, he also outlined the criteria for choosing industries which included, inter alia, contribution to knowledge and experience and provision of linkages (Shafaeddin, 2000).

Finally, List does not regard trade policy as a panacea; by contrast, he regards the theory of commercial policy as an element of a comprehensive package which includes a host of other socio-economic policies: industrial, financial and educational, as well as a large number of complementary factors such as infrastructure, institutions, science and technology, inventions, entrepreneurial development, etc. But policies, including trade policies, should be country-specific, as there are no universal rules which can be applied to all countries (ibid.).

B. Import substitution versus export expansion? (Raul Prebisch)

The views of Raul Prebisch are also often misinterpreted. It is true that at a particular point in time he advocated import substitution, but this was a specific strategy for a specific period. His proposal was by no means intended to be at the cost of export expansion; in fact, it was regarded as a means to it. In practice, however, his views were badly implemented – or were not implemented at all, as will be explained shortly. Let us first discuss what he advocated.

Raul Prebisch[13] composed his theory of import substitution in the early 1950s. Emphasizing the need for industrialization, he believed that import substitution, even though costly, was inevitable at the time because of the lack of an industrial infrastructure and of unfavourable external market conditions for exports of manufactured goods (Prebisch, 1984). At that time, such terms as inward-looking industrialization, import substitution and infant industry protection were used interchangeably. Nevertheless, he never said export expansion was unnecessary; he said it was difficult.

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[12] Ricardo made a similar argument (ibid.).

[13] See UN (1950); for a short description of the evolution of Prebisch's thinking on trade and industrialization policy see Singer (1986), Dell (1986), and Prebisch (1984).

Moreover, Prebisch soon made it clear that import substitution should be a step towards export expansion, and not a permanent feature of industrial strategy. In the late 1950s, Prebisch began to refer to the limitations of import substitution, the costs of excessive and across-the-board protection, its adverse impact on exports, and the absolute necessity of building up trade in industrial exports (Prebisch, 1959: 259, 265, 268). Subsequently, in his report to UNCTAD I in 1964, Prebisch developed his views on the defects of "inward-looking industrialization", as practised and experienced by developing countries.[14] These included, he explained: frequent and considerable waste of capital; the adverse effects on exports of manufactured goods owing to high costs of production and a slow rise in productivity related to the smallness of national markets; the lack of a programme to develop industries on a selective basis; the reduced capacity and flexibility to deal with periodic shortfalls in export earnings; and, finally, the detrimental effects on the quality of output and production costs caused by the insulation of the national market due to excessive protection (UN, 1964: 20–23). Accordingly, he added:

> The development of industrial exports, in addition to counteracting the potential trade gap, will make it possible gradually to increase the advantage of industrialization by correcting its defects. This applies not only to the developing countries which have already started this process …, but also *to others* [our italics], especially those which have emerged with the colonial system (ibid.: 22).

At this stage in Prebisch thinking, industrialization was not confined to import substitution, and infant industry protection was not limited to production for the domestic market. It could also apply to export activities, through selective subsidization of exports in order to face cost differential with the "centre" (Prebisch, 1984: 181).[15]

Finally, in the early 1970s, Prebisch argued for "a gradual reduction in the protection afforded to industry in order to introduce the stimulus of competition" (Dell, 1986: 13). In the mid-1980s, while Prebisch emphasized the importance of indigenous technology and domestic food production through import substitution, he also referred to the need for a mixture of export promotion and import substitution to increase the domestic value added in export activities (see Singer, 1986, for details).

Dell emphasizes correctly that the founder of the theory of import substitution was 20 years ahead of his critics; "he had been fully aware of the pitfalls [of import substitution] before these studies [by his critics] appeared" (Dell, 1986: 10). The important difference between Prebisch and the neoliberals, however, is that the latter misinterpreted Prebisch's theory and often regarded outward orientation, or export promotion, as synonymous with "trade liberalization".

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[14] This was the case when the easy stage of import substitution of light consumer goods reached its limit and continuation of such policy would require substitution for imports of intermediate and capital goods. See Dell (1986).

[15] Prebisch argued in favour of export subsidy and provision of preferences (GSP) for imports of developing countries to the industrial countries, as selective measures, as against devaluation as a means of providing uniform incentives to various products (Prebisch, 1959: 256–257; UN, 1964: 74–75).

C. Implementation problems

Another fallacy is the attribution of the failure of an import substitution strategy in many developing countries to the theory of infant industry protection. The reality is that, with the exception of East Asian economies, hardly any other developing countries have followed infant industry protection, as proposed by its founders. Moreover, many developing countries, in fact, did not undertake "import substitution" as an element of infant industrial policy. On the contrary, in many of them some sort of across-the-board import substitution took place in reaction to import restrictions imposed as a result of various balance-of-payment crises. For example, in Latin America, the Middle East, North Africa and independent Asian economies, severe import restrictions were imposed on imports during the Great Depression of the 1930s, which continued during the Second World War. During the post-war period also the majority of developing countries faced boom and bust cycles in their economies caused by changes in world demand and prices for primary commodities, which were their main export products. Each bust was accompanied by tightening of import control. Similarly, the oil price rise of the 1970s contributed to such import restrictions for balance-of-payment purposes rather than as a means of industrial policy. If any criticism is to be made of developing countries, it is that the majority of them did not have an industrial strategy, or did not have a clear one. Today, they still suffer from the same problem, as across-the-board trade liberalization cannot be a substitute for a trade and industrial policy.

As mentioned earlier, infant industry should be an element of a dynamic industrial strategy, which at each point in time should aim at selective support of certain industries, while reducing or eliminating support for others (for more details see Shafaeddin, 1995).

V. CONTRADICTIONS IN THE GATT/WTO RULES

Let us assume for a moment that there is a theoretical justification for universal trade liberalization and the theory of static CA is accepted as the philosophy behind such liberalization. The theory would indicate that developing countries should specialize, inter alia, in production and exports of primary commodities and labour-intensive goods for which they have abundant production factors. The GATT/WTO rules suffer from contradictions in their design and in their implementation by industrial countries, as far as trade liberalization is concerned.

A. Contradictions in design

While the objective of GATT/WTO is trade liberalization, the related rules suffer from a number of contradictions. These include, for example, issues related to trade in agriculture, main labour-intensive products of export interest to developing countries, and coverage of the infant industry clause.

1. Agriculture

International trade should be free, but not for agricultural goods. This was the message of the introduction to the original article of the GATT: "… [by] entering into reciprocal and mutually advantageous arrangements directed to the substantial reduction of tariffs and other *barriers to trade and to elimination of discriminatory treatment in international commerce* [our italic] … have … agreed …".[16] In other words, international trade should not be the subject of discriminatory treatment. Nevertheless, agricultural goods, which were of interest to many developing countries, were not covered by the Agreement.[17]

Furthermore, in 1955 the Contracting Parties granted the United States a waiver in respect of its obligations under articles II and XI, when these were in conflict with its Agricultural Adjustment Act of 1933, which provided for the imposition of import fees and quotas (McGovern, 1986: 453–454). Regulation of the agricultural sector was raised at the Tokyo Round, but was strongly opposed by the European Community, which refused that its Common Agricultural Policy (CAP) be called into question.

Occasionally (as in 1978 and 1980) issues related to various processed agricultural products have been the subject of dispute in GATT panels. FAO attempted to regulate disposal of surplus agricultural products in order to prevent harmful interference with normal patterns of production or international trade, or with prices caused by sales of government-held stocks in exceptional volume or at exceptional pace. For this purpose, FAO developed the concept of the Usual Marketing Requirement (UMR).[18] Otherwise, trade in agricultural products has escaped international regulations – except for a number of commodities which have every now and then been subject to international commodity agreements – which have mostly been ineffective (McGovern, 1986, chap. 15). Nevertheless, both the United States and EEC/EU (European Economic Commission/European Union) have heavily intervened in production and trade in agricultural products through their support and stabilization programmes. For example, in the United States, there were programmes on wheat, maize, cotton, soya beans, rice, wool, barley, oats, sugar and a number of other products. Similarly, the EEC/EU has intervened in the production and trade of agricultural goods through CAP, mainly in the form of price support and subsidies. The legal base of such intervention is the EEC Treaty, which provides for an individual policy stance for nearly all agricultural products. Once again, while particular aspects of CAP have now and again been examined by GATT, by and large it has escaped international regulations (op. cit.). Heavy subsidies paid to the farmers through CAPs in Europe and the United States and tariff and quantitative restrictions applied to agricultural goods by many developed countries during the post-war period have continued. Governments in most industrial countries have protected agriculture through tariffs, quantitative restrictions, prices and direct income support of the producers and input subsidy.

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[16] Introduction to the text of the General Agreement on Tariffs and Trade (GATT) in 1949.

[17] For a short history of regulations on trade in agriculture see McGovern (1986, chaps. 14 and 15).

[18] For details see McGovern (1986).

> According to OECD estimates, consumption expenditures on domestically produced [agricultural] commodities was 34 per cent higher than at world market prices. Total support to OECD agriculture from consumers and taxpayers (TSE) was estimated at US$ 362 billion in 1998 (Cahill, 1999: 31).

Note that this amount is, on the basis of UNCTAD data, about five times higher than the total exports, including petroleum, of sub-Saharan Africa, 3.7 times that of exports of the African continent, over 14 times higher than exports of least developed countries, and nearly a quarter of all exports of developing countries as a whole in 1996.

The URA aimed at some reduction in subsidies on agricultural goods over time, but agricultural trade liberalization is still one of the stumbling blocks in the proposed new round.

2. Textiles, clothing and footwear

According to GATT rules, international trade in manufactured good should be subject to reductions in tariffs and other barriers, but not for the main labour-intensive products of export interest to developing countries. Moreover, according to GATT rules, tariffs are preferred to quantitative measures, but not for the same articles. Textiles and clothing fall into an important labour-intensive product category, which accounted in 1997 for about 60 per cent of total exports of manufactured goods from developing countries.[19] Nevertheless, while the GATT rules were supposed to govern manufactured goods, textiles and clothing were excluded, contrary to the spirit of GATT in trade liberalization. These products were subject to import barriers through Multi-fibre Arrangements (MFAs). Under MFAs, which came into operation in 1974, restrictive quotas were imposed by developed countries on imports of such products from the main developing countries.

Under URA, textiles and clothing became subject to the Agreement on Textiles and Clothing (ATC). Nevertheless, once again there was a contradiction. While developing countries, with the exception of the least developed ones, were supposed to implement rapidly most URA provisions, the MFA was to be phased out gradually in different steps within 10 years, i.e. by 2005. Moreover, integration of clothing, which involves higher value added and which is subject to higher protection (tariff peaks), has been left to the final stage of the phasing-out period. Above all, even when MFA is phased out, the tariffs on textiles and clothing in some industrialized countries, such as EU members, will remain higher than those for other commodities (IDS, 1999: 4).

In addition to textiles and clothing, imports of a number of other products of export interest to developing countries have been subject to quantitative restrictions in industrialized countries; these include, among others, footwear and jute (Das, 1999).

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[19] Based on WTO (1998, tables 44 and 45).

3. Infant industry protection

Another contradiction under URA is allowing, in a certain sense, infant industry protection for the development of specific industries of main interest to developed countries, but not those of essential interest to developing countries. This is a step backwards as far as the latter are concerned. To explain, article XVIII of GATT allows, under certain conditions, the use of protective measures for the "protection of *particular* industries" in the case of countries in early stages of development. In other words, not only was infant industry protection allowed, but the principle of "selectivity" was also accepted. Thus, developing countries could eventually apply a dynamic trade policy for the development of their industrial base by selecting specific industries for protection and others for liberalization at each point in time.

Under URA, developing countries are, in effect, denied such privileges. Subsidies provided for R&D on specific activities is allowed, but those provided for the expansion of exports and export supply capabilities are not (Agreement on Subsidy and Countervailing Measures [ASCM], articles 3 and 8).

To explain the contents of these articles: article 3 prohibits subsidies to be paid to firms (except for agricultural products) "upon export performance" and "upon the use of domestic over imported goods" (inputs). Definition of subsidies for export performance includes "direct subsidy", currency retention, preferential internal transport and freight charges on export shipment, as against domestic shipment and preferential provision of "imported or domestic products or services for use in the production of exported goods" (ASCM, annex I).[20]

As far as article 3 is concerned, there is a contradiction on the definition of specificity contained in article 2. According to paragraph 2.1.a, a subsidy is prohibited if it is "specific": a subsidy is specific when the authorities limit it to specific enterprises or industries; otherwise, it would not be specific. By contrast, according to para. 2.3, all subsidies falling under the provisions of article 3 are regarded as specific. In other words, even if all industries were provided with subsidies tied to export performance or which favour domestically produced goods, the subsidy would be regarded as specific. The implication of this article is that a country cannot support its infant industries, whether or not for exports, either across-the-board or on a selective basis, when the subsidy is tied to export performance – a practice common until very recently, particularly in East Asian countries.

Para. 8.2.a provides exceptions to the specificity clause, even if assistance is given to specific enterprises or industries. It covers research activities undertaken by firms and/or research and educational establishments, up to 75 per cent of costs of industrial research, or 50 per cent of the costs of pre-competitive development activity. Para. 8.2.b allows for "non-specific" assistance to a country's disadvantaged regions, provided that clear and objective criteria is used in the definition of such regions. The criteria should be based on development indicators, which should at least cover a measure of income or

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[20] If, however, subsidy is provided to an enterprise without being made legally contingent upon export performance, it would not be prohibited: "The mere fact that a subsidy is granted to enterprises which export shall not for that reason alone be considered to be an export subsidy …" (ASCM, para. 3.1.a, footnote 4).

employment. Accordingly, the income per capita of the region should be at least 85 per cent of the average for the country. The unemployment rate should be at least 110 per cent of the country average. In this case, even though the subsidies are non-specific, export activities located in the region could benefit from them. Hence, there is room for manoeuvring. Currently, there is discussion on granting subsidies to British Rover for regional equality.

Para. 8.2.c allows assistance for the adaptation of existing facilities to new environmental requirements of up to 20 per cent of the related cost on a one-time basis, provided it is available to all firms concerned. There are certain general conditions attached to article 8 concerning prior notice to WTO, provision of information, etc.

R&D activities are concentrated in developed countries for the development of new technologies, new products and new processes – a development which is, in a sense, an "infant" activity involving risks and requiring provision of extra incentive to those firms engaging in it. In developing countries, by contrast, "application" rather than "development" of a new technology or a new process is important in the elaboration of supply capabilities and export expansion. The transfer and efficient application of technology for the expansion of export capacity takes time and involves costs and risks, as does development of marketing, brand names, etc., before an industry can mature and export products become internationally competitive. During this period, infant industry protection is often required. Incidentally, in the agricultural sector, subsidies used by developed countries (as in R&D, crop insurance, and so on) are allowed, but those most used by developing countries (e.g. input and land improvement subsidies) are subject to countermeasures (Das, 1999: 157).

B. Contradictions in implementation of commitments

The main advantage of trade liberalization under WTO for developing countries is providing them not only with market access but also with "security of market access" by subjecting the trading partners to established and agreed procedures. While access to markets could contribute to export expansion, and thus exports proceeds, the security of market access could reduce uncertainty and risks involved in exportation to developed countries, thereby preventing arbitrary decisions by member countries. The reduction in risk, in turn, would contribute positively to the process of decision-making and planning for investment in production and export capacity.

The experience of recent years, however, indicates that there are contradictions between the way commitments to URAs are fulfilled in developed countries. Such contradictions have been particularly noticeable in the areas of ATC, anti-dumping clauses and safeguard mechanisms – all contributing to increased uncertainty, and therefore risks, of market access for main exports of interest to developing countries.

1. Agreement on Textiles and Clothing

The contradictions in the implementation of URA are best explained in the words of the Secretary-General of UNCTAD in a letter to the *Financial Times* (11 December 1999) concerning textiles and clothing:

> What does it mean to have a market-driven, multilateral trading system if it is not to allow those countries that *have a comparative advantage in certain sectors* to exploit those strengths to the hilt [italics added]? Over half a century after the birth of the GATT, a few industrial countries continue to drag their feet on liberalizing their textiles industries, claiming they need still more time to adjust. Meanwhile, they insist that weak developing countries swallow the bitter medicine of adjustment to agreement on issues such as TRIPS as quickly as possible – preferably in under five years …

According to the text of ATC, MFA is supposed to be completely eliminated by 2005, and trade in textiles and clothing integrated into WTO rules. The phasing-out, however, is intended to take place in four stages; 1995, 1998, 2002 and 2004. So far, the implementation of the commitments by developed countries has been slow. By integrating unimportant items into WTO rules first while postponing items which are important for developing countries, the implementation of ATC has been slowed down. For example, in the case of both the United States and the European Union (EU):

> The way in which integration targets have been met runs contrary to the spirit if not the letter of the ATC. Included in the integration schedules of the EA [EC] and the USA are a large number of non-textile and non-clothing products that happened to contain textile components, such as umbrellas, car seat belts and parachutes. Such items accounted for a full 58% of the EA's first-stage integration schedule, but were less evident in second stage (IDS, 1999, Briefing No. 4: 2).

According to the same source, in the cases of both the United States and EU about two thirds of their ATC imports remain to be integrated into WTO rules – which might not happen until 2005.

To explain in more detail, according to paragraphs 6 and 8 of article 2 of ATC, at least 16 per cent of textile products were to be integrated in January 1995, 17 per cent in January 1998, 18 per cent in January 2002, and 49 per cent by the end of 2004. According to the integration programmes so far developed for stages 1 and 2 (1995–2002), the products selected were concentrated in less-value-added items, with only a small share being allocated to clothing. For example, the percentage share of clothing was 3.9 out of 33.24 (a percentage of 1990 imports of textiles and clothing, which is supposed to be integrated into WTO rules by the end of stage 2, i.e. end of 1992) for the United States, and 2.53 out of 33.31 for EU. Moreover, the contribution of integrated items to the value of imports of textiles and clothing items has been small. The annual share of freed items in the value of imports during the period 1995–1997 was around 6 per cent for the United States and 4 per cent for EU (ITCB, 2000a: 6–9).

Paragraphs 13 and 14 of article 2 of ATC also provide "for additional increase in quotas access". Restraining countries were required to "increase existing growth rates of quota" by at least 16 per cent during stage 1, another 25 per cent during stage 2, and a further 27 per cent during stage 3. For the period 1995–2001 the total increase in access by EU has been only 4.49 per cent, by the United States 6.36 per cent, and by Canada 7.53 per cent (ibid., table 6).

There are also a number of other areas where the implementation of ATC has fallen short of commitments (ibid.). Furthermore, a recently proposed plan for EU's integration programme for stage 3 of ATC would indicate that by the end of the phase-out period, i.e. end 2004:

(i) although 51 per cent of trade will have been integrated, a large bulk of it comprises products which are not under quota restriction;

(ii) only 52 out of 219 quotas will have been liberalized by the end of the 10-year transitional period;

(iii) 79 per cent of restrained trade will remain under quota restriction right up to the end of the ATC period unless, in the remaining years of ATC, EU undertakes further liberalization steps; this would involve virtually all main traded products.

The constraining effect of continued restrictions is also apparent from the European Commission's own findings that, whereas total EU imports increased by 31 per cent between 1995 and 1999, imports from WTO members under quota restriction expanded by only 20 per cent during the same period (ITCB, 2000b: 5).

2. Applying anti-dumping rules

Many developing countries feel that the way anti-dumping rules have been used in practice is in contradiction with the spirit of WTO rules governing trade liberalization. These rules allow a country to take countermeasures if dumping takes place and "causes or threatens material injury to an established industry" in the importing country (article VI of GATT). Anti-dumping measures have been used by some developed countries as a pretext for protectionism, for example against imports of textiles, clothing and steel (Das, 1999).

The conceptual issues involved in anti-dumping measures make their use to some extent arbitrary. Article VI of GATT and article 2 of URA on implementation of article VI define dumping as selling a product to another country below its "normal value". The normal value is defined as the sale price in the exporting country or, in its absence, the sale price in a third country, after allowing for various sale and transport costs (transaction costs) or for the differential transport costs. In calculating the normal value, the "unit cost" plus a reasonable margin is allowed for. Such definition of normal value and unit cost suffers from two practical problems. First, in business, particularly in exportation, marginal cost-pricing is often a normal practice. in particular, when an industry is subject to significant scale economies (e.g. steel), marginal cost-pricing takes special importance. The presence of economies of scale would allow export prices to be lower than domestic sale prices because as sale increases the unit cost declines.

Second, as far as comparable prices in a third country are concerned, differential pricing is another practice. An exporter prices its products in different countries at different prices, depending on the tastes, level of income and size of the market which affects its average marketing cost. One can find many examples of such practices in the case of electric and electronic appliances in Europe, the United States and developing countries, by exporters from Germany, Japan and the United States.

Article VI of GATT would imply that the necessary condition for action by the country experiencing dumping is that dumping takes place, and the sufficient condition is that it causes or threatens material injuries to an established industry. Let us assume that a country possesses an efficient export industry and has CA in exporting products of that industry (e.g. textiles, steel, etc.), or is capable of competing better owing to devaluation (devaluation changes export prices in the international market without necessarily affecting domestic prices, at least in the short run); assume now that the course of events is the opposite to what is envisaged in article VI. An inefficient industry in an importing country complains that it is injured due to imports as a result of dumping. This complaint is submitted, according to the normal procedures, to the government which decides whether or not to consider the case as dumping and pursue it in WTO. (Since the definition of dumping is somewhat arbitrary, the government will have considerable latitude as to whether to refuse a claim or accept it and refer the issue to WTO). Usually, this decision is influenced by political lobbies by industrialists and trade unions in the importing countries. Moreover, the fact that the government of the importing country has some discretionary power to levy countervailing duty on imports under exceptional circumstances (para. 6 c of article VI) before the issue is settled by WTO is enough to create disturbances, uncertainty and risks for the firm of the exporting country.

Developing countries claim that the fact that anti-duping complaints are often used essentially against products in which they have CA (such as textiles, clothing, base metals, steel, etc.) is an indication of using anti-dumping through implementation of article VI as a pretext for protectionism. Developed countries accounted for 68 per cent out of 2,196 cases of dumping investigations by GATT/WTO between 1987 and 1997. Out of 1,501 cases investigated by developed countries, 591 (39 per cent) cases were against developing countries and 340 (23 per cent) against countries in transition (*Financial Times*, 29 October 1998), based on WTO data.[21]

The arbitrary nature of dumping allegations is evident by the fact that many of the investigations undertaken did not prove the act of dumping. Nevertheless, the very nature of successive investigations has been detrimental to exports of developing countries. For example, in the case of cotton fabrics, the total imports of EU from non-EU countries dropped by 6.52 per cent in 1997. In the same year its imports from six countries targeted for investigation declined by over 33 per cent. For 1993–1997, when investigations were in progress, the imports of targeted countries declined by an annual rate of 7 per cent (ITCB, 2000a).

Similar evidence is available regarding the arbitrary nature of safeguard action. For example, in an examination by Textile Monitoring Body of WTO, restrictions imposed by one restraining country on imports of textiles and clothing during 1995–1998 indicated that most of them "were not justified and that the restraining country had not complied with obligations under the Agreement" (ibid.:15).

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[21] It should be mentioned that some developing countries were also very active in using anti-dumping clauses. For example, Argentina, Mexico and South Africa figured among the 10 main countries initiating anti-dumping cases in WTO (UN, 1998).

3. Differential treatment of developing countries

When unequal partners engage in negotiations on trade liberalization, for a fair outcome the weaker party might expect some differential treatment, as in a process of give-and-take the weaker partner has less to give. In other words, freer trade should accompany fair trade. In GATT this principle was to some extent accepted, for example, for infant industry protection, inter alia. URA still contains some special and differential treatment, particularly for least developed countries. Nevertheless, in practice, developed countries have done little to implement their commitments, such as, for example, a commitment to give priority to the removal of trade barriers on products of interest to least developed countries, to refrain from introducing new barriers on these products, or to encourage imports from these countries (Das, 1999: 158–59).

The governments of developed countries are evidently under pressure to liberalize trade in agriculture and labour-intensive products slowly for social reasons. However, here again there is a contradiction. Why should developing countries liberalize rapidly? Social and employment issues are also important in developing countries. Developing countries expect to be given time and assistance to make their inefficient industries efficient, or to reallocate resources from those industries to other activities if they are unlikely to become efficient. Nevertheless, many developing countries have been under pressure through WTO rules, the World Bank and bilateral financial arrangements to liberalize their industries prematurely and/or sharply. The result in many least developed countries, in particular, has been the destruction of their existing industries without any significant replacement; the outcome has been severe unemployment, lower income, social deprivation and marginalization. In most of these countries some simple processing of raw materials has been encouraged; otherwise, they become locked in production and exports of primary commodities.

One argument sometimes used as a justification for pressure laid by the United States on developing countries to liberalize their trade regime is an increase in the US current account deficit in recent years. However, as explained in section VI, the development of the deficit in the current account of the United States is not caused by developing countries, nor can it be remedied by trade liberalization in such countries; it will lead to worsening of their current account deficits with possible financial crisis, as has been the case in recent years. Moreover, there appears to be another contradiction in this argument: if large current account deficits are problematic for developed countries, why should they not be so for developing countries too, as explained below?

VI. INTEREST OF DEVELOPED COUNTRIES

So far, we have discussed the needs and interests of developing countries. However, it is important to examine the question: is universal, premature and sudden trade liberalization by developing countries always in the interest of industrialized countries? This question arises because in 1996, according to UNCTAD data, developing country markets accounted for 24 per cent of exports of developed countries, 15.2 per cent of

exports of EU (39.6 per cent when intra-EU trade is excluded), 52 per cent of exports of Japan and over 42 per cent exports of the United States. In this context, it is sometimes argued that trade liberalization in developing countries contributes to access by developed countries to developing country markets, particularly in Asia, which has been growing faster than world trade over the past decade.

For example, according to Larry Chimerine of the US Economic Strategy Institute, the principal economic interest of the United States Government seems to be to open up other markets in order to reduce its trade deficits: "without some mechanism to open up markets for US products and services, particularly in Asia, there is no prospect of controlling US trade deficits that is approaching $300 billion a year. In his view that is an economic and political time bomb waiting to explode at the first sign of an economic downturn in the United States" (*International Herald Tribune*, 9 December 1999: 4).

Here again there is a fallacy for a number of reasons. First, it is true that the United States runs worldwide current account deficits. Nevertheless, such deficits are not due to import restrictions in developing countries. Nor could trade liberalization in developing countries necessarily contribute to resolving that problem. Developing countries, with a few exceptions, do not run surpluses in their current accounts; they spend the last penny of their foreign exchange earnings on imports of goods and services. In fact, except for periods during which they have to run surpluses to pay for their debts, they show deficits in their current accounts. As may be seen in table 2, Singapore and Kuwait are the only two developing countries with some current account surplus for the period 1988–1999. Both countries have almost absolutely free trade regimes. Otherwise, the surplus countries are exclusively among industrialized countries, with the exception of China. It is interesting to note that even oil-exporting countries, as a group, have been running deficits in their current accounts since 1985, except for the two periods 1989–1990 and 1996–1997 (see table 3): the surplus during the first period was due to a sudden increase in the price of petroleum during the Persian Gulf crisis; during the second period, the surplus was created for the repayment of debts. Developing countries usually import in excess of their foreign exchange earnings by financing their deficits through various capital inflows and borrowing on international markets. Although capital inflows are unstable – so that a part has to be allocated to increases in reserves – various financial flows have generally been significant in determining the import capacity of developing countries (UNCTAD, 1999b, chaps. IV and V).

With respect to the above-mentioned statement by Larry Chimerine, it should be noted, however, that liberalization efforts can change the structure of imports of developing countries, which in essence may benefit some developed economies more than others. For example, it is possible that liberalization of services, particularly financial services, may benefit the United States more than other countries.

Secondly, since developing countries do not run surpluses, any increase in their imports – unmatched with increases in exports – caused by liberalization would lead to increase in their current account deficits (as shown in table 3). The current account deficits of non-oil exporting countries increased nearly threefold between 1990 and 1994, when a large number of developing countries undertook trade liberalization through World Bank and IMF Structural Adjustment Programmes and Stabilization Programmes. The UR trade liberalization was accompanied by almost doubling of the current account deficits of those economies

between 1994 and 1997. Note that over the same period industrialized countries as a group considerably increased their surplus. In other words, while trade liberalization resulted in significant increases in imports of developing countries, the expansion of their imports was not accompanied by sufficient liberalization in their main export markets. To continue, the debts of developing countries resulting from deficit financing have ultimately to be paid through exportation or debt forgiveness. Hence, when their export market is not expanding sufficiently, a financial crisis will evolve, as occurred in Asia and Latin America in 1997–1998.

Table 2

Indicators of the current account surplus of various countries, 1989–1998

Country	*Surplus ($USA billions) (1998)*	*Number of years with surplus (1989–1998)*
Japan	12.1	10
Belgium	12.1	10
Netherlands	27.7[a]	9[b]
Switzerland	23.7[a]	9[b]
France	40.2	71
Italy	20	6
Denmark	0.9[a]	8[b]
Sweden	4.6	5
Norway	- 2.1[c]	9
Ireland	1.5	8
Singapore	17.6	10
Kuwait	2.9	9
China	29.7[a]	7[b]

Source: IMF (1999).

a 1997.

b 1989–1997.

c The surplus for 1997 was $8 billion.

Thirdly, the emergence of such financial crises involves significant costs for the industrial countries in terms of lower growth and greater instability in trade and GDP overtime[22] and the expenses related to the bailout of debtors. This is exactly what happened in the case of Asian crisis. The financial crisis led the crisis-

[22] See UNCTAD (1999b) for more details.

stricken countries to take macroeconomic measures to limit their imports and expand their exports, although at the cost of losses in their terms of trade. As a result, the industrialized countries' exports to these Asian economies – as well as to other developing countries affected by the crisis – was negatively affected. Hence, although exports of industrialized countries to developing countries initially expanded fast as a result of the once-and-for-all effect of trade liberalization through UR, over a longer period it resulted in a slower average growth rate of their exports to these countries. Consequently, growth in their GDP was negatively affected as well (with the exception of the United States).[23] Taxpayers were also affected by the loss of employment and income.

Table 3

Current account deficits and surpluses of developing and developed countries, 1985–1998

	Developed countries	*Developing countries ($USA billions)*				
		All [a]	*Oil exporters*	*Non-oil exporters*	*China*	*Non-oil exporters – China*
1985	- 65.8	- 18.2	- 0.9	- 17.6	- 11.4	- 6.2
1986	- 41.7	- 34.1	- 28.6	- 5.4	- 7.0	+ 1.6
1987	- 75.5	+ 11.1	- 11.3	+ 22.4	0.3	+ 22.1
1988	- 65.6	- 8.5	- 20	+ 11.5	- 3.8	+ 15.3
1989	- 83.6	- 10.7	+ 1.8	- 12.4	- 4.3	- 8.1
1990	- 106.2	- 13.2	+ 19.5	- 32.7	+ 12.0	- 20.7
1991	- 38.4	- 83.7	- 60.2	- 23.5	+ 13.3	- 36.8
1992	- 36.3	- 74.7	- 25.5	- 49	+ 6.4	- 53.4
1993	+ 40.2	- 115.2	- 22.1	- 93	- 11.6	- 81.4
1994	+ 18.3	- 67.4	- 6.1	- 61	+ 6.9	- 67.9
1995	+ 51.9	- 96.8	- 2.8	- 94.2	+ 1.6	- 95.8
1996	+ 39.4	- 82.1	+ 26.0	- 108.1	+ 7.2	- 115.3
1997	+ 70.5	- 79.8	+ 20.5	- 100.3	+ 29.9	- 130.0
1998	- 37.6	- 46.3	- 12.9	- 33.3	N/A	N/A

Source: Based on IMF (1999).

a Includes China.

[23] It should be mentioned that the United States was exceptionally less affected by the crisis because of the lower share of trade in its GDP – a coincidence of the crisis with the technological revolution in the United States and serious countercyclical measures taken by the Federal Reserve Bank. Nevertheless, the country's current account deficits expanded significantly.

Fourthly, one may argue that trade liberalization has been to the benefit of TNCs in their attempt to globalize. It is true that these companies will enjoy greater freedom in movement of goods across boarders and in their commercial presence. It is also true that they have benefited temporarily from the expansion of their markets in developing countries. Moreover, they have further benefited through the acquisition at low prices of the fixed assets of some developing country firms (TDR, 1990, chap. V). Nevertheless, they have been also affected negatively by the economic crisis of recent years. This may be seen, for example, by the performance of such global firms as Coca-Cola, Disney and Gillet. If "financial crisis" are repeated – and they will be – they will also suffer in the long run from lower growth and instability in their earnings.

Finally, it is true that the United States' current account deficit has increased by approximately 40 per cent from about $168 billion in 1987 to about $234 billion in 1998. Nevertheless, as a percentage of the country's exports (of goods and services), it has declined from about 45 per cent to 24 per cent over the same period; in relation to its GDP, it has declined from 3.5 to 2.8 per cent. Here two points may be added. The first is that, taking into account in particular the strength of the US economy, such a deficit ratio is far less worrisome than that of the developing countries; for example, in 1996, the corresponding ratio was respectively 8.4 for Malaysia, 8.1 for Thailand, 4.7 for the Philippines, 5.4 for Chile, 5.5 for Colombia, 17.1 for the Dominican Republic, 38 for Malawi, 45 for the Congo, and 15.4 for the United Republic of Tanzania.[24] The second point, as put by a developing country official, is the contradiction that "when developing countries run deficits, they have to adjust and liberalize trade; when industrial countries run deficits, 'others' should adjust". But even if others are supposed to adjust, "others" should refer, according to J.M. Keynes, to countries with a surplus, not to those in deficit. It should also be mentioned that part of the reason for the increase in US deficits in recent years is the country's high rate of GDP growth, which necessitates increases in imports, including petroleum and other raw materials.

VII. CONCLUDING REMARKS: TRADE NEGOTIATION AND DEVELOPING COUNTRIES

An attempt has been made in this study to discuss some causes of the failure in setting the agenda for the next round of trade negotiations under the auspices of WTO. The study has focused on frictions between developing and industrialized countries in the particular area of trade in manufactured goods, which is the main concern of developing countries (but developed countries did not wish to include it on the agenda of the coming round). It was argued that as regards the interests of developing countries, two prime factors have contributed to the failure: fallacies surrounding both the theory of universal and across-the-board trade liberalization, and the theory and practice of infant industry protection – and a contradiction in the design and implementation of GATT and WTO rules to the detriment of the interests of developing countries. It was also

[24] Based on IMF (1998).

shown that rapid and across-the-board liberalization is not in the interest of developed countries – let alone that of developing ones.

Taking into account the prevailing fallacies and contradictions in trade policy theory and practice and bearing in mind the experience of trade policy and diplomacy in recent decades, one is led to conclude that there is a need to design a new trade policy for developing countries as well as to revise international trade rules. In this respect, in preparing themselves for trade negotiations, developing countries need to draw up a clear strategy; the elements of such a strategy could entail the following. First, developing economies need to be clear as to whether they prefer to play a "passive", a "defensive" or a "proactive" role in the negotiations. In the past, they have been passive on some issues and defensive on others. By the latter stance, they opposed what was put on the table by developed countries, as they were either sceptical of the goodwill of the industrialized countries or unsure whether the proposed issue was in their interest. It should be emphasized, however, that negotiation involves a process of give-and-take, which in turn entails bargaining. In bargaining, one needs to play a proactive role.

Secondly, in a proactive role, developing countries both as a group and individually need to adopt a clear position about the type of trade policy they wish to follow – as was stressed by the Secretary-General of UNCTAD in the *Positive Agenda for Development.* The philosophy behind the "positive agenda" is that instead of opposing whatever is proposed by developed countries in the WTO round of trade negotiations, developing countries should come up with their own trade negotiation agenda. It is maintained that such an agenda should be designed from a development perspective, and that developing countries should make the necessary preparations for the negotiations (UNCTAD, 1997: 1–8). This approach implies that before entering the negotiation process, individual developing countries should be clear about their trade strategy; that such a strategy should be linked to their development objectives in general and their industrial policies in particular. Moreover, they should be able to analyse the impact of present international rules and regulations on their development prospects. Furthermore, if they choose to be proactive, they also need to request, in cooperation with each other, changes in the present rules. However, as developing countries are not a homogeneous group, instead of agreeing on a "least common denominator", they should attempt to cooperate with one another in a strategy aimed at the trading rules that differentiate countries, in accordance with some agreed criteria. Such criteria might include a number of indicators such as per capita income, the degree of dependence on primary commodities, the share of manufacturing in GDP, etc.

Thirdly, unless they accept being locked in the production and exports of primary commodities, simple processing and "traditional light manufacturing goods" or rather "manufacturing commodities", developing countries need in the long run to have a dynamic trade policy geared to their level of development, industrial capacity and structural characteristics, as well as to changes in world economic conditions and competitive situation. Although there is no general formula on trade policy because each country's is different, the reader may refer to Shafaeddin (1995) for a proposed outline of such a trade policy. It should be emphasized that trade policies also require a clearly defined industrial and development strategy, as mentioned above, and should allow developing countries some flexibility as they develop.

Fourthly, as each country or group of countries tries to look after its own interests in the process of negotiations, it is a myth to believe that concessions will always be made to developing countries on "moral grounds". In fact, according to the *Financial Times* (2 December 1999: 14): "The EU and the US are still at loggerheads, and still intend on bullying developing countries, without offering much in return". "Bargaining" is the name of the game. Bargaining requires bargaining chips, information about the issues under negotiation and bargaining skills. Bargaining chips are the net sum of bargaining assets and liabilities. One should bear in mind that the bargaining chips of developing countries are smaller than those of developed ones. Hence, the issue boils down to the best use of whatever bargaining chips they possess by its proper mobilization. Such a process requires knowledge, information about the issues concerned and training for undertaking negotiation. In such a context, at the country level there is a need not only for policy formulation and for strengthening the capacity of commercial diplomacy so as to enhance the country's bargaining skills, but also for strengthening the capacity for trade and industrial policy formulation within the context of its general development objectives and strategies.

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