

1986

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## Citation of this paper:

Wolf, Martin. "Developing Countries in the Global Trading System." Centre for the Study of International Economic Relations. Global Perspectives Lecture Series, 1986-02-G. London, ON: Department of Economics, University of Western Ontario (1986).

61230

ISSN 0831-7089  
ISBN 07714-0793-9

THE CENTRE FOR THE STUDY OF INTERNATIONAL ECONOMIC RELATIONS

GLOBAL PERSPECTIVES LECTURE SERIES

1986-02-G

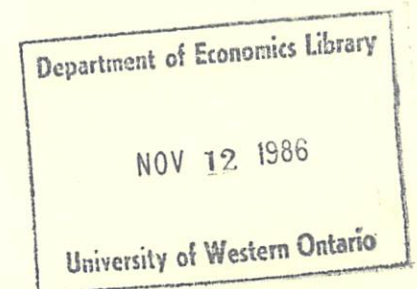
DEVELOPING COUNTRIES IN THE GLOBAL TRADING SYSTEM

Martin Wolf

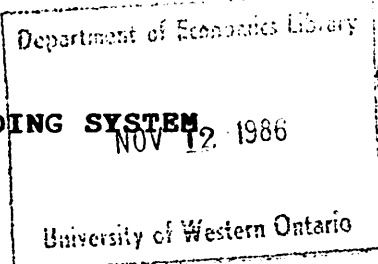
April 13, 1986

This paper contains preliminary findings from research work still in progress and should not be quoted without prior approval of the author.

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**DEVELOPING COUNTRIES AND THE GLOBAL TRADING SYSTEM**



LET ME start with an explanation of the background to this particular talk. The Trade Policy Research Centre (TPRC) decided some years ago both that there was likely to be another major round of multilateral trade negotiations (MTN) within the General Agreement on Tariffs and Trade (GATT) in the 1980s and that it would determine the basic structure of commercial policy for the world for the rest of this century and quite a bit of the next. Furthermore, we suspected that one of the major issues would be the role of developing countries in the trading system.

Accordingly, a programme of studies was undertaken on the topic of the Participation of Developing Countries in the International Trading System. What I am going to do is review a central part of that programme, concentrating on two of the studies. One is by a well-known legal scholar, Professor Robert Hudec of the University of Minnesota, who has analysed the history of developing countries in the GATT legal system. The second study is by Professor James Riedel, at Johns Hopkins University's School of Advanced International Studies in Washington. His paper reviews external constraints on the growth of developing countries. The present lecture is essentially a synthesis of these two studies, highlighting their implications for the next MTN. The approach taken is a broad and synoptic one, the main theme being the interaction between economic ideas, economic developments and international arrangements. Because of the breadth of the coverage many important issues will not be

adequately addressed.

I will start below with the demands of developing countries on the international trading system and their origin. The discussion then turns to the way in which the developing countries have been fitted into the GATT. The succeeding section deals with the implications of economic developments themselves. Whereupon, the current impasse in the trading system is analysed. Finally, there will be a discussion of what might happen in the MTN that would actually improve the situation.

#### DEMANDS OF DEVELOPING COUNTRIES

Let us start off with a little history. The starting point is the view almost universally shared in developing countries and among economists working on developing countries in the 1940s and 1950s that there was something fundamentally different about the economic problems of developing countries. Normal economics did not apply. There were rigidities in their structures of production and constraints on their access to external markets that made them fundamentally different. Let me mention some of the main ideas underlying this view.

There was, first, the 'engine of growth' theory, associated in particular with the Norwegian economist Ragnar Nurkse and the Argentinian economist Raul Prebisch. The idea was that, in the past, rising demand for primary commodity exports from developing countries had generated growing amounts of foreign exchange,

economic growth. But, for various reasons that I will not be able to examine, it was argued that the engine could not be relied upon in the post-war years. The developing countries would, therefore, not have such an external stimulus for growth, their trading environment being extremely inauspicious.

The second influence was both the experience of the 1930s and 1940s and the legacy of those years. Among the legacies of the 1930s and 1940s in all the independent developing countries of that time, and particularly in Latin America, were high protective barriers. An import-substituting industrialization process had already started, and in the 1940s and 1950s the process was going well, at least from the perspective of the countries concerned.

The final influence, particularly important as developing countries freed themselves from imperial systems, was the strong association of the free trade or liberal trade view with imperialism, particularly for the countries that had been in the British Empire.

The suspicion of liberal trade led to two major demands upon the international system. The first was simply that developing countries should be free to protect their economies, effectively without limit. Such protection was thought to be the only way to augment disposable foreign exchange since, by assumption, exports could not grow rapidly. By saving foreign exchange and using the foreign exchange to import investment goods and so achieve higher rates of investment, developing countries would meet the

necessary conditions for economic growth. So there was a perceived need to protect, and in order to be free to protect, developing countries had to be free from any internationally agreed discipline on the structure of trade policy, particularly disciplines aimed at liberalizing trade policy. This was the dominant view in developing countries of the 1950s and it has continued to have force ever since.

The second demand reflected the subsequent view that the strategy of import substitution was not working, in the sense that foreign exchange was not getting less scarce but scarcer as protection rose. There were many reasons for this disappointing development, but perhaps the most important was simply that a tax on imports is a tax on exports. Developing countries were finding in the 1950s that their export performance was dismal. So the thrust of their demands moved to something slightly different. It was not good enough just to be free to protect, export performance had to improve as well. But developing countries, so it was thought, could not compete equally with developed countries and, indeed, with highly protective trade regimes it was difficult for them to compete in export markets. So there then evolved the demand for preferential improvements in access to developed country markets.

Historically, the shift to an emphasis on market access was associated with a famous report written in 1958 for the GATT contracting parties by a distinguished group of economists under the chairmanship of Gottfried Haberler. That report rightly emphasised the need for improved market access. But developed

countries were unwilling to grant broad, non-discriminatory and liberal access on products of interest to developing countries, while developing countries wanted preferential access. It was only through preferential access, developing countries thought, that they would be able to compete successfully with the developed countries.

That viewpoint became dominant between the time of the Haberler Report (1958), and the first meeting of the United Nations Conference on Trade and Development (UNCTAD), which occurred in 1964. It is worth remembering again the interaction of ideas and institutions. The first Secretary General of UNCTAD was Raul Prebisch. He was, of course, an Argentinian, and Argentina was one of the countries that had pursued the protectionist line of policy longest and with the greatest zeal. It was through the first UNCTAD that the second major demand of developing countries, namely that a general structure of preferences in favour of developing countries should be built into the trading system, became fully focussed.

So the two fundamental demands of developing countries both related to basic ideas about the global economy. One was the need to pursue import substitution without any external constraint, and the second was the need for preferential market access. These have remained the principal demands of developing countries on the trading system since this time.

## DEVELOPING COUNTRIES IN THE GATT

Now, let us look at how this all fits into the GATT. The GATT is a strange system looked at from the economic point of view. The harsh truth is it has very little to do with economics or economists and the reason is that trade policy, in general, has little to do with economics and economists. If there are any economists here who believe that it has, then I suggest they disabuse themselves of this notion very quickly. This does, I suppose, reflect one of the greatest failures of economics as a subject. It is only by seeing the system in its own terms that one can have any idea of how trade policy actually works.

The GATT is an international contract, one which I have referred to elsewhere as a peace treaty for mercantilists. It is an agreement in which the benefits are export access and the costs are import liberalization, the idea being that there should be a balance of costs and benefits. This balance comes about through reciprocal bargaining; reciprocity, an idea with which you are all familiar.

Reciprocity is naturally bilateral, but the damage that strictly bilateral reciprocity can do is evident from its potential for creating complex discriminatory structures. This potential danger of reciprocity was supposed to be contained in the GATT by a number of legal principles of which by far the most important is non-discrimination, especially the so-called most-favoured nation (MFN) clause. A second principle was that the trade policy instruments would be transparent, so that countries



could bargain productively and could also not cheat too easily. The only instrument allowed in the GATT (with a few exceptions) is the tariff, and tariffs were also meant to be bound. This then was the essential structure of the GATT: reciprocal bargaining constrained by the side conditions of (i) non-discrimination, (ii) use of the tariff and (iii) the binding of tariffs.

The point to remember about reciprocity, however, is that it implies that liberalization is costly. Furthermore, the problem of liberalization vis-à-vis developing countries from the developed country point of view is that the latter have very little to offer, even if they want to bargain. Remember also that, in the case of trade with developing countries, one is dealing with quite fundamental differences in comparative costs. The pattern of comparative advantage of developing countries is quite different from that of the developed countries. In order to accept trade with developing countries, therefore, developed countries, who do not see any very attractive reciprocal bargain on offer, have to accept that specialization is desirable. But since the developed countries do not accept that idea, but believe rather that liberalization is costly, there has been a tendency, already clear in the late 1950s, to control those imports from developed countries that compete strongly with their own labour-intensive manufactures. The system for regulating imports of clothing and textiles, which is a very important part of the background to the developments I am discussing, dates from 1961.

How then did the developed countries fit developing countries into the GATT? Remember that when the issue became important in the late 1950s and early 1960s, there was a great increase in the number of developing countries. There was a strong feeling, therefore, that the GATT had to absorb these new states and so become a universal institution. Developed countries could not allow the GATT to remain, as it used to be considered, a 'rich man's club' and they were also fearful of the competition from UNCTAD. But probably equally important was the 'welfare imperative', the general view that aid in its broadest sense should be given to developing countries, and this should be done through trade policy as well as in other ways.

Developed countries found two solutions. The first and easiest in mercantilist terms, was to 'help' the developing countries by progressively releasing them from all the constraints upon their own policies. That was what developing countries wanted and, since the accepted idea in the GATT was that liberalization was costly to the liberalizing country, it was impossible for the developed countries, who had accepted this viewpoint in their own bargaining, to resist this demand of developing countries. One of the results was that reciprocity disappeared vis-à-vis developing countries. Moreover, review of developing country attempts at customs unions and free trade areas, which proliferated in the early 1960s, was basically given up. Furthermore, review of the use by developing countries of restrictions for balance of payments purposes, a very important loophole in the GATT, became notional. So, as a consequence of the combination of the welfare view and GATT mercantilism, the

developing countries were liberated from all discipline on their own trade measures. They joined the institution, but they had effectively no obligations under it.

But that freedom was insufficient. The second thing that developing countries were pushing for was preferences. The United States alone resisted strongly, the reasons being American attachment to the principle of non-discrimination. The United States and the European Community tended to disagree fundamentally on the issue of preferences. The United States resisted generalized preferences for developing countries for a long time, but finally, in 1971, a waiver was granted in the GATT for generalized preferences for developing countries.

So, between 1958 and 1971 pretty well everything that the developing countries had demanded of the trading system was granted to them. As a result developing countries joined the GATT in large numbers, though some important countries did not join, Mexico, for example. There can have been no economic reason for this, since there is nothing that Mexico did that would not have been permitted under the GATT.

In joining, developing countries became 'contracting parties'. After all, the GATT is a contract. Developing countries are contracting parties of the GATT, therefore, but they are very special contracting parties because they do not contract to do anything. There is no substantive obligation. There are certain formal procedural obligations, but there is nothing in the trade policy of developing countries that is

affected one way or the other by their membership of the GATT. Mexico's policies were really no different from those of its neighbours because it was not a part of the GATT.

The developing countries had won what they saw as a victory. From the developed country point of view, however, the defeat was costless because they did not care very much whether developing countries did or did not obey the rules of the GATT. All they wanted was a fairly free hand to protect when developing countries were unpleasantly competitive. Protection by developing countries could easily be used to justify protection against them. Indeed, one constantly hears arguments in trade policy circles that since the developing countries do not accept any obligations towards the developed countries, why should the developed countries accept any towards them? When dealing with highly competitive countries or particularly sensitive industries developed countries have created a complex and steadily evolving structure of discriminatory protection.

The whole emerging relationship was referred to once by Harry Johnson as 'neo-neo-colonialism'. What happened in the end was that the developing countries were absorbed into the GATT system de jure, but not de facto. The GATT became universal by simply appending to its body some 60 members who were what one might describe as 'non-contracting contracting parties'.

#### **ECONOMIC DEVELOPMENTS**

In the meantime, ideas about the problems of developing

countries and the experience of developing countries as well evolved. There are exceptions, but I think the majority of economists would no longer accept the economic views and theories on development of the 1950s.

One aspect of the experience with the GATT is that as the developed countries went through the process of bargaining in the GATT, their trade policies became increasingly similar. Policies of developed countries, particularly those of the United States and the countries of Western Europe, are characterized by (i) generally low tariffs, but with peaks; (ii) voluntary export restraint arrangements (discriminatory restraint arrangements), to control imports of manufactures where comparative cost differences are large; (iii) a tendency to discriminate against what are considered ultra-competitive 'free-riders' on the liberal system, particularly Japan and certain East Asian suppliers; (iv) the spread of American ideas concerning fair trade, principally countervailing duties and anti-dumping and (v) a failure to liberalize in the same sensitive sectors, especially agriculture and textiles and clothing. So you have the dominant economies with essentially the same trade policy structure and that structure has largely been generated by the process of bargaining in the GATT that I have described.

Developing countries, by contrast, have very varying policies, with different instruments and different structures of protection because developing countries were free to pursue any policy they wanted, they did, in fact, pursue any policy they wanted. Some developing countries pursued relatively

liberal policies. Some pursued very protective policies.

One of the more remarkable outcomes is that the 'four little dragons' of East Asia -- Hong Kong, Singapore, Taiwan and the Republic of Korea -- moved from nowhere in the 1950s, to accounting for 50 per cent of all exports of manufactures from developing countries by the late 1970s and early 1980s. The Republic of Korea alone exported more manufactures than the whole of Latin America.

On the other side of the same coin is India, which accounted for half of all the manufactured exports of developing countries in the mid-1950s. India now accounts for about 7 to 8 per cent of the manufactured exports of developing countries.

So there were tremendous differences in performance among countries. At the same time, there were large overall changes in the structure of developing countries exports. This is, indeed, the main point that James Riedel makes in his study: the declining relative importance of primary commodity exports, on the one hand, and the growing importance of manufactures, on the other. Above all, for developing countries as a whole exports that one could describe as 'competing', that is to say, exports for which the price elasticity of demand in world markets is relatively high and which absorb a small part of the markets of the developed world, became increasingly important.

So the view that developing countries are dependent on export of a single primary commodity (the so-called monocrop

economy), a view on which many of their demands had been based, was becoming less relevant. There are certainly many countries which are still very specialized, but diversification is quite general. Furthermore, the share of developing country exports in the developed country markets for manufactures has remained small. Even at the end of the 1970s, that share was only about 3½ per cent of the total market. The problem has increasingly become one of access to markets rather than the existence of markets, as had been feared in the immediate postwar era.

The success of developing countries with exports of manufactures and the change in the structure of their exports is important. In many ways the more advanced developing countries have similar problems to those of the smaller developed countries. This changing reality is associated with a new academic orthodoxy on trade policy, with which you are all familiar. The research I would mention in this context includes the OECD project synthesized by Ian Little, Tibor Scitovsky and Maurice Scott, the work of Bela Balassa at the World Bank, and the work subsequently done at the National Bureau of Economic Research (NBER) by Jagdish Bhagwati and Anne Krueger.

Basically, what they all found is that export incentives work. Some countries seemed to have been able to export, with incredible success, even in the teeth of protectionist barriers. These results suggest that the export pessimism of the 1950s just does not make sense. Subsequent research, which is surveyed and further developed in the Trade Policy Research Centre's programme on the Participation of Developing Countries in the International

Trading System by Rolph Langhammer and André Sapir, suggests that the continued successes of these countries really have nothing to do with generalized preferences. It was not that the GSP was harmful, but rather that it was marginal.

So the whole developing country agenda for the trading system no longer seems very relevant. The implication has been drawn by most economists that the developing countries have laboured mightily in the GATT to achieve certain aims and, having achieved them find them not so much a mouse as a rat. Unfortunately, and this is a problem to which I will return, there is really nothing in the GATT framework to tell them that this is so, because the GATT does not say that liberalization is desirable. On the contrary, it tends to say that liberalization is costly.

#### **PRESENT IMPASSE**

There now is an impasse. The developed countries, and particularly the United States in the last ten years or so, have become increasingly obsessed by what they see as the 'graduation problem'. The demand for graduation is a natural consequence of the evolution described. There are simply too many 'free riders' as developed countries see it, countries that gain the 'benefits' of the GATT system without bearing its 'costs'. Some developed countries are determined that the principal developing countries, the ones that are important players in this game, behave more like developed countries. Essentially, they want to reverse many of the concessions that they gave in the 1950s and 1960s or at



least draw a new, better defined and more stringent line dividing the 'real' developing countries from the rest.

The developing countries resist this idea. Why? What are the reasons for the resistance?

First, whatever intellectuals may now think about the development process, developing country policy makers do not, on the whole, accept the new neo-classical orthodoxy. Policy-making elites in most developing countries, still tend to go along with the old orthodoxy about development that was discussed at the beginning of this talk.

Secondly, governments of developing countries believe that the various 'concessions' which developed countries have made to them are rights and should not be given up for nothing. What is more, they argue, with considerable justice, that when the developed countries make demands upon them they are merely being hypocritical, because the developed countries have never shown a willingness to abide by the fundamental disciplines when inconvenient to themselves. Accordingly, developing countries assert that they should neither have to trade legal for illegal barriers nor be expected to accept disciplines in new areas like services, for example, when developed countries have consistently failed to do what they have promised. In effect, developing countries regard the GATT as a flawed institution, and believe that any fuller participation by themselves is pointless until those flaws are rectified and are unconvinced that such fuller participation would itself lead to a rectification of those

flaws.

The question one has to ask, therefore, is whether anything can be done within a new multilateral trade negotiation, given the legacy of history in the form of a collapse of discipline on both sides. Let me register my pessimism. A personal view is that the moral capital in the GATT system is more or less depleted, simply because too many countries have played fast and loose with the system whenever convenient. In this situation there really is, unfortunately, no effective way of saying: 'Let us forget the past. Now we are going to follow the rules'.

#### **OPTIONS FOR NEGOTIATIONS**

Nevertheless, what issues would arise if one were to try both to tighten up the system and help developing countries to liberalize? The discussion is organized by noting that in an MTN developing countries would have two sorts of objectives: to improve the policies of developed countries and, secondly, to improve their own.

#### **Improving Market Access for Developing Countries**

How might the developing countries go about improving the policies of developed countries? Within the GATT framework the only influence a country can have is through bargaining. The trouble with this particular device is that it simply does not work very well for small countries. And it has not worked for small developed countries any more than for small developing

countries.

In the first place, let us look at tariffs. There have been two approaches to reciprocal bargaining of tariffs in the GATT. The first was the so-called principal supplier rule. The principal suppliers of particular commodities involved themselves in direct negotiation, with any agreed reductions in protection extended to all other GATT contracting parties. This rule had, however, proved unworkably complex by the end of the Dillon Round in 1962 and GATT negotiations then shifted to across-the-board cuts. The Kennedy and Tokyo Rounds centred on negotiations among major developed countries about formulae for general tariff cuts, and then negotiations about exceptions to those formulae. What the United States cared about was the formula that would be applied by the European Community and (later) Japan, and the same was true for the other two players. None of them has ever really cared about what Australia would do, for example. And there is no reason to suppose that their attitude would be any different in the case of almost all developing countries.

What then can the Republic of Korea offer the United States that would 'buy' MFN liberalization of tariffs on American imports of textiles and clothing? Not much, I suspect. If the developing countries were to operate reciprocal bargaining effectively, they would have to cooperate among themselves and that would be spectacularly difficult, because the interests of developing countries diverge radically. (Again, by interests I mean interests perceived in mercantilist terms.)

In the second place, there is the problem of non-tariff barriers (NTBs) to trade. By now, much (although not all) of what really matters is NTBs, but the GATT has never dealt effectively with such barriers. It is not designed to and it is not obvious that it could. The only effective multilateral programme for liberalizing non-tariff barriers of which I am aware was in the Organization for European Economic Cooperation (OEEC) during the 1950s and that was an agreement to liberalize in parallel. Countries agreed year-by-year that they would make an increasing proportion of their trade NTB-free. The GATT has never followed this approach.

A significant problem here is that, as has been mentioned, on the developing country side, most non-tariff barriers are formally legal, particularly the extensive use of quantitative restrictions for balance-of-payment purposes. The same is not true for the developed countries, many of whose barriers are at best of dubious legality. If a negotiation is to be within the legal framework of the GATT, therefore, one would have to trade legal restrictions for illegal ones. The developing countries insist that that is impossible.

When non-tariff barriers have been dealt with in the GATT, the preferred method has been the negotiation of codes of behaviour, general rules governing how a country may operate under certain situations. How does one negotiate a code? One cannot really negotiate the language of a law among 80 countries. What actually happens is that very few countries matter in the negotiation. Developing countries have then come

along and said, 'we are owed special and differential status'. So at the end of every code there is a clause or two which says the code does not really apply to developing countries, the most important example being the code on subsidies and countervailing duties. It seems difficult to imagine how developing countries as a body can play an effective role in these sorts of negotiations.

In short, there is probably little that developing countries will, in practice, obtain from bargaining in the GATT. I should mention, in this regard, one of the cautionary tales of post-war trade policies, namely that of Australia. Australia has been waiting for 40 years for liberalized agriculture. Since nobody has liberalized agriculture, Australia has bound few of its tariffs and generally kept them high. It remains, I think, the most protectionist among the significant developed countries. So here one has a classic example of the dangers of operating on a bargaining chip theory of trade policy when nobody wishes to pick up your chips.

### **Improving Developing Country Policy**

The other side of the coin is the question whether absorbing the GATT more completely in their own policies can help developing countries. Here, too, there are problems. First and most important, the GATT system endlessly repeats the basic mercantilist fallacy. But more specifically, there is a series of escape clauses in the GATT that were designed largely for the United States, and these escape clauses can really only be

operated by countries like the United States. Countervailing and anti-dumping duties come particularly to mind here and, to a lesser degree, emergency protection. A country needs to be able to generate and process an enormous amount of information to operate these provisions effectively, quite apart from having a disciplined quasi-judicial system, but these do not exist in developing countries. The likelihood is that if they tried to absorb these provisions they would just become an excuse for policies as chaotic as the ones they now follow. There are a great many GATT clauses that allow protection, clauses that could be used by developing countries quite easily, just as the balance-of-payments exception is now, and that are likely to prove equally counter-productive.

#### **UNILATERAL VERSUS MULTILATERAL LIBERALIZATION**

The admittedly tentative conclusion is that there is probably little developing countries can do within the GATT system either to improve their market access abroad or improve their own trade policies at home. Developing countries are too ineffective for the former and the GATT itself is too ineffective for the latter. On the whole, developing countries should be encouraged to liberalize unilaterally.

Now one might say that unilateral liberalization is not very plausible; but it is actually no less plausible than that developing countries will liberalize significantly in the context of the GATT. Moreover, it is quite unlikely that the developed countries would choose to try to force developing countries to

liberalize or accept GATT disciplines. To do so would necessitate a willingness by the United States, in particular, probably against strong resistance from the European Community, to adjust its own trade policies to those of the developing countries on a strictly bilateral and reciprocal basis. But this would be to dismantle the GATT system.

In addition, if developed countries wanted to force developing countries to change their policies and maintain any credibility, they would also have to accept greater discipline over their own policies vis-à-vis developing countries. It is unlikely that they would wish to accept such discipline. Indeed, the absence of discipline over developing country policy is a convenient excuse for protection in developed countries.

So the bottom line is that, if pushed on the subject, developed countries would admit that they are as happy with the present situation as with any feasible alternative. There is an impasse in the system. The GATT cannot liberalize effectively along the the North-South divide. Moreover, it is not at all obvious that there is any way of making it do so.

This raises two final questions: should one look for a fundamentally different international system? Or should one simply advise developing countries that the best thing is largely to forget about the international system? Since they can achieve nothing within it, should they be advised to follow the normal recommendation for small countries, of unilateral free trade? These \$64,000 questions are best left for another occasion.

1986

- 1986-01-G Nove, Alec. WHAT WILL GORBACHEV DO?
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