# UNIT 11 TRADE AND DEVELOPMENT

**Structure**



## 11.0 OBJECTIVES

After reading this Unit, you will be able to

- rationalise import substitution industrialisation strategy;
- learn about the changes in research on trade policy and growth; and
- discuss trade policy and performance in the eighties and nineties.

## 11.1 INTRODUCTION

Trade policy has always been considered to be an important component of a country's development strategy. During the past half a century there has been a sea change in the view of analysts regarding the nature of an appropriate trade policy. Whereas fifty years ago there was a consensus among economists and policy makers that an appropriate trade policy should protect infant industries in the country, today there is a consensus in favour of an export oriented trade policy[1]. We discuss in this Unit, why a protectionist trade policy often called a policy of import substitution industrialisation (ISI) was adopted and how it fell out of favour. We also discuss the current views of what an appropriate trade policy should be.

The debate for much of the late fifties and the sixties was centred around Prebisch's thesis of declining relative prices for primary commodities. Some questioned Prebisch's analysis of the historical data. Others like Cairncross

[1] There have always been some economists who did not concur with the majority view such as the earlier views of Prebisch and now Rodrik and Taylor. But dissenters have been few.

argued that even if terms of trade for primary commodities had declined in the pre-Second World War period it was no longer true in the post war period. The arguments of these economists seemed to be bolstered by the buoyant prices for primary commodities in the fifties and sixties, actually till the mid-seventies. You will learn about this issue in detail in the next unit 12 of this block. In the mid-sixties the focus of the debate turned towards the question as to what ISI policy had achieved. Had it been a success in fostering economic development? The conclusion both from cross country analysis and detailed country studies was that the ISI strategy had been a failure. But there were enough ambiguities in the results that the conclusion was not always accepted. Also the static inefficiencies identified by this analysis were very small and it was not very convincing that they could lead to large differences in growth rates. We discuss the analyses, the conclusions and the weaknesses in these studies.

Because of the weaknesses in the studies attention in cross country analysis shifted towards finding a relation between trade policy and growth rather than the earlier attempt to find a relation between trade performance and growth. Also attention shifted from analysis of static inefficiencies to looking at the dynamic effect of trade policy.

## 11.2 RATIONALE FOR AN IMPORT SUBSTITUTION INDUSTRIALISATION STRATEGY

In order to understand the rationale for Import Substitution Industrialisation strategy, it is important to know why this kind of industrialisation strategy is needed? What were the appropriate tools used for this strategy. But let us first learn why developing countries needed industrialisation at first place.

### 11.2.1 Why Industrialisation?

Economists trying to devise a strategy for development at the end of the Second World War took account of the dependence of almost all developing countries on exports of primary products. Prebisch, among others, argued that expansion of primary production and exports would not lead to development. Due to low income and price elasticities of demand for such products, expansion of export volumes would not result in a corresponding increase in export earnings as prices will decline. Import payments, on the other hand, would increase with rising imports of capital goods as investments increased in the attempt to raise growth, because these countries did not have a significant production of capital goods. So countries would face worsening terms of trade and balance of payments (BOP) crisis when they tried to accelerate their growth. The BOP deficits would force a cutback in investment plans and slow down growth. Since development could not be based on growth of primary output it was necessary to base development on industrialisation.

A further argument as given by Rosenstein-Rodan in favour of industrialisation in over-populated countries was that land pressure in these countries had resulted in very low labour productivity and prospects for agricultural growth were very limited. Industrialisation was the only way to absorb the surplus labour force in agriculture and grow.

### 11.2.2 Why Import Substituting Industrialisation?

Industrialisation based on producing import substitutes rather than producing for exports was recommended. Such import substituting industrialisation would tackle many of the constraints to faster growth. Nurkse had argued that one of the factors limiting investment in developing countries was lack of demand. But if imports were restricted, it would create demand for previously imported goods, so entrepreneurs could be depended upon to invest in import substituting industries. Also, economists were in general pessimistic about prospects of the world economy based on the experience of the inter-war years. They expected the world economy to grow very slowly; there was supposed to be a bias towards stagnation. Economists like Nurkse also expected the continuation of the pre Second World War pattern of countries adopting extensive restrictions on trade, particularly, on exports of labour intensive goods from developing countries. Furthermore, developing countries were expected to need time to develop the skilled and productive labour force necessary to be competitive in the world market. For all these reasons, many economists recommend the adoption of an ISI strategy for development.

### 11.2.3 Appropriate Tools for Implementing an ISI Strategy

Important policy issues in implementing the ISI strategy were what instruments to use and who was to be responsible for investment?

Countries tended to adopt quantitative restrictions (QRs) to curtail imports. This was because QRs were believed to provide more certain signals to prospective investors in the protected industries. The impact of tariff protection could be uncertain as prices might fluctuate. (You should revise the discussion of tariffs and quotas from Unit 4 to help you understand this point.)

Furthermore, most countries adopted an import substitution strategy in consumer goods industries, with the private sector playing the leading role in undertaking investments. It was believed that stoppage of consumer goods imports would lead the transnational corporations (TNCs) who were supplying the imported goods from abroad to undertake the production of similar goods in the developing country itself, thereby solving the problems of adequacy of investible funds, technology transfer and of shortages of entrepreneurship.

A few countries, mainly India, also undertook import substitution in capital goods industries under the aegis of the state. Such state sponsored industrialisation raised more complex issues of generating sufficient investible funds as well as getting the technology to establish the plants to produce the capital goods.

**Check Your Progress 1**

1) Why developing countries required industrialisation?

..........................................................................................................

..........................................................................................................

..........................................................................................................

..........................................................................................................

2) What strategy was adopted by developing countries for industrialisation? Discuss.

..........................................................................................................

..........................................................................................................

..........................................................................................................

..........................................................................................................

3) What were appropriate tools recommended for implementing ISI strategy?

..........................................................................................................

..........................................................................................................

..........................................................................................................

..........................................................................................................

## 11.3 RESEARCH AND CHANGES IN TRADE POLICY IN THE MID-SIXTIES

It is pertinent to ask was there any research that took place on trade policy as such? If yes, then in what context was this research undertaken by economists? Was it in terms of export performance and growth or in terms of trade policy and efficiency or productivity growth? These are the questions that this section is going to answer.

### 11.3.1 Early Experience with ISI and Adjustments in Policy

Most developing countries adopted ISI policies initially. But adoption of ISI policies did not free developing countries from repeated BOP deficits and crises. Exports grew slowly. Both domestic firms and the TNCs producing consumer goods had no incentive to export these consumer goods, as they had a protected domestic market that was far more profitable. Countries, which had adopted a policy of import substitution in capital goods industries were not able to export these goods as often these goods did not incorporate the latest technologies or because costs of production were high as scale of production was small or because exports of capital goods are often tied to provision of supplier's credits and these countries were not in a position to provide such credit. While exports stagnated, imports continued to grow rapidly, as when a good was produced domestically, imports of intermediate goods used in its production went up even though imports of that good went down.

Many policy analysts recommended South-South regional trading arrangements (that is, trade between developing countries themselves) to resolve the problem created by the small size of the domestic market. You will learn about regional trading blocs in Unit 15. It was argued that such regional arrangements would lead to rationalisation of industries among developing countries and so to plants of an economic size, which could then compete in the world market. The old belief that world trade would grow slowly was rejected as world trade grew very rapidly in this period.

But South-South trade did not really take off. It proved very difficult to reach agreement on measures to ensure an equitable distribution of the benefits from such an arrangement. The more advanced country in the regional grouping would benefit more as it could expand its manufactured exports more. Most schemes sought to balance the benefits by allocating industries among countries. But this did not work, as it was difficult to allocate industries among countries as satisfactory allocation criteria were lacking. Also no country was willing to give up the option of establishing an industry so that all countries wanted all industries. Even schemes that started satisfactorily failed after a few years often because of differences regarding the distribution of benefits.

Other countries adjusted their policies. Many countries mainly Korea, Taiwan, Singapore and Hong Kong in East Asia and Brazil and Colombia used the exchange rate to encourage exports. These countries were able to successfully increase their export earnings and achieve a high rate of growth of GDP. A number of other countries sought to soften the bias against exports of their import substitution policies by using a variety of subsidies to encourage exports.

In some cases policies fluctuated between periods of relatively liberal polices and periods of relatively more restrictive polices. For instance, India had carried out a policy reform in the mid-sixties in which it had removed many of the subsidies and tariffs it levied and instead devalued. It was believed as Bhagwati states that such a move would provide clearer signals to investors as otherwise the plethora of schemes made the calculation of the overall effect difficult. But because of poor rainfall exports did not increase immediately. Also the aid promised to finance the initially higher BOP deficit after liberalisation did not materialise. Soon the trade regime again became restrictive, and, because of the cutback in aid, more restrictive than it had been earlier.

### 11.3.2 Research on Trade Policy and Growth

Extensive research was conducted from the mid-sixties on the impact of trade policy on economic performance. This research as Bruton mentions, tended to concentrate on the problems either not solved by the ISI approach or created by that approach and tended to ignore the achievements.

The main conclusions of this research that were stressed were that ISI policies resulted in substantial inefficiencies that had a detrimental effect on economic performance. Countries, which followed an export oriented trade policy performed better than countries, which followed ISI policies. Also countries did better in periods where they adopted more liberal policies than when they adopted more restrictive policies.

Three types of analysis of the link between trade policy and growth in productivity and income were undertaken. Initially, cross-country regressions were run on growth of GDP against some measure of export performance. These regressions, however, did not provide the reasons why better export performance resulted in higher growth of GDP. Also it was realised that export performance depended on many factors. Later in the 90s, analysts tried to correlate trade policy to growth of GDP. The shortcomings of the cross country analysis was sought to be rectified by more in depth country studies that sought to identify the channels through which trade policy affected economic performance. The third set of studies operated at a micro level and sought to study the effect of trade policy on performance at the industry or even the firm level. In particular, they concentrated on the effect of trade policy on productivity growth.

### 11.3.2.1 Export Performance and Growth

There have been two stages in cross-country regression analysis of the relation between openness and growth. In the first stage (surveyed by Edwards (1993) growth was regressed against variables representing export performance. Then, in the nineties, the analysis moved towards examining the relation between trade policy and growth rather than between trade performance and growth.

Studies, which tried to estimate a relationship between export performance and growth based on cross section samples of a number of countries, measured export performance by indicators such as the share of exports in the GDP, or the change in the export share or the growth of exports. Initially, economists found a significant positive relation between growth in GDP and export performance (Balassa (1973) and Michaely (1977)). But this approach was criticised on several grounds. Balassa's study analysed a small sample of eleven countries, including Korea, Taiwan, India and Chile, which may bias the results.[2] Furthermore, since the GDP includes exports, faster export growth would lead to faster GDP growth. The more appropriate test to regress growth of non-export GDP on export performance often showed no effect.

Goncalves and Richtering (1986) found a significant Spearman rank correlation coefficient between the growth rate of GDP, the export growth rate, and the change in share of exports in GDP, but not between export performance and the growth rate of non-export GDP. Taylor (1986) also found 'that differences in trade policy orientation had little to do with how successfully countries responded to the external shocks of the seventies.' Batchelor, Major and Morgan (1980) in a detailed analysis found that the exports of manufactured goods played a significant role in the development of only small semi-industrialised countries where the small size of the market was an obvious constraint.

In a remarkable article Sheahy found a significant relation between growth and almost all other major categories in the national accounts, whether these aggregates were from the demand side or from the production side. In many cases the impact of these other national income aggregates was more important than that of exports. Our interpretation of Sheahy's result, and thus of all cross country regressions, is that a regression of growth and any national income aggregate measures the backward and forward linkages of that aggregate. The larger these linkages are, the more important is the interrelation; the more is the sector an enclave type, the less significant is the linkage.

In the nineties analysis has shifted towards finding a relation between trade

[2] A similar criticism was levelled against the contention in the World Bank's World Development Report's (1987) categorisation of countries into four groups: the first consisting of very open economies which, apart from Hong Kong and Singapore, were too small to be significant, otherwise contained only

policy and growth performance. A major problem in such studies is to find appropriate indicators of openness. Analysts have responded by using a large number of indicators and trying to show that the result of a positive relation between openness and growth performance is robust and does not depend on the indicator chosen.

Sachs and Warner define an economy to be closed if it satisfies any one of five conditions: (i) an average tariff rate greater than 40%, (ii) Non Tariff Barriers (NTBs) covering more than 40% of product lines, (iii) socialist system of production, (iv) state monopoly in trade, and (v) a black market premium for the exchange rate of more than 20% either in the 70s or in the 80s. They find a significant relation between openness and economic growth.

Dollar uses an index of real exchange rate distortion and its variability to denote trade policy. Recall from Unit 4 that a protectionist policy means that domestic prices of import competing goods would be higher than international prices and prices of exportable products would be lower than international prices. His index of distortion is the price index relative to that of the US from the Summer and Heston work on PPP compared to a predictor of the relative price from a regression of price against GDP, its square, regional dummies for Latin America and Africa as well as year dummies. The distortion is a ten year average of the relative price. The variability is measured by the coefficient of variation of the annual values of this. He finds significant effect of distortion and its variability of distortion on growth.

Edwards follows the alterative strategy of using many indicators and showing that the results are robust and do not depend on the indicator used. He uses nine indicators: (i) the Sachs-Warner index, (ii) the World Bank's subjective classification of trade strategies in the WDR 1987, (iii) Edward Leamer's (1988) openness index, built on the basis of the average residuals from regression of trade flows, (iv) the average black market premium on foreign exchange, (v) the average import tariffs from UNCTAD as given in Barro and Lee (1994), (vi) the average coverage of NTBs also from UNCTAD through Barro and Lee, (vii) the subjective Heritage Foundation index of distortions in international trade, (viii) ratio of total revenue from trade taxes to total trade, (ix) Holger Wolf's regression based index of import distortions in 1985. Edwards finds a robust relation between his indicators and growth.

But Rodrik and Rodriguez (RR) find statistical and conceptual short-comings with these analyses. For instance, when the variables are used independently only state monopoly and black market premium on exchange rate of the Sachs and Warner study are significant and not the others, but neither of these variables is closely related to trade policy. They show that the state monopoly in trade is almost synonymous with a dummy variable for Sub Saharan Africa. Similarly, as soon as they introduce regional dummies the variable distortion becomes insignificant which suggests that the results with distortion may be spurious and reflect omitted regional factors. Other variables such as exchange rate premium in Edwards or variability in distortion in Dollar reflect more macro imbalance than trade policy. Sustained macro imbalance is bound to affect economic performance independently of the nature of the trade policy.

In a detailed analysis RR show that Edwards' results are largely the result of the weighting scheme he adopted and the identification assumed.

When R&R use the more appropriate White's method for undetermined heteroscedasticty pattern, they then cannot replicate Edwards' results. Also when a different specification is adopted in the case of instrumental variables, only the two subjective variables—the World Bank's index and the Heritage Foundation Index are significant. There are substantial problems with these subjective indices. So, substantial doubts continue to exist about the relationship between trade policy and growth.

#### 11.3.2.2 Trade Policy and Efficiency

Aggregate cross sectional analysis does not reveal the channels through which trade policy might affect economic performance. Detailed analysis of the impact of trade and industrial policy was undertaken in two major projects. The results of the two studies are summarised in Little, Scitovsky and Scott (1970), Bhagwati (1978), and Krueger (1978). Their conclusions were somewhat similar in that the countries following more open export oriented policies and using the market mechanism rather than quantitative controls had performed better.

We follow the discussion in Bhagwati, as this is a detailed analysis of the working of trade and industrial policies. Bhagwati argued that the operation of a QR regime resulted in inefficiencies, as the lack of sufficient relevant economic information resulted in the allocation of licenses among the many alternative users on the basis of some notion of equity rather than on the basis of economic costs and benefits. For instance, licenses for the import of raw materials were often allocated proportionately to installed capacity. Since the output of efficient firms was limited, there would be a demand for the output of inefficient firms, who would also receive their share of licenses. Bhagwati also argued that an efficient firm might get additional imported inputs for larger production only by expanding capacity, even though it may have under-utilised capacity. Bhagwati identified the major static inefficiencies as excess holding of inventories, capacity underutilisation, the choice of inappropriate techniques of production of due to distorted factor prices, and inefficient allocation of investment.

But the evidence is mixed as the quantitative controls system may itself frustrate the achievement of the allocations desired by economic agents in response to the incentives created by the system. For instance, the granting of licenses may take time, so producers may desire to hold excess inventories of imported intermediates. But licenses for sufficient imports to hold the excess inventories may not be granted, so the actual level of inventories may not reach the desired level above the normal level of inventories. Also, other factors might explain the excess inventories. Though Turkey, which had a restrictive regime had a high ratio of inventories, Chile, which also had a restrictive regime, had a lower ratio than Japan and Spain and a ratio only slightly higher than in France and the USA. There is considerable variation even among the developed countries. But, more importantly, a high ratio of inventories in some countries could be explained by the size of the country and the efficiency of its transport system rather than the trade regime. Furthermore, the larger share in LDCs of agriculture and agriculture based industries with a longer turnover period would imply that the ratio of inventories to fixed investment or GDP would be higher in LDCs because of their structure of production.

The experience of most countries which have liberalised would bear out the conclusion that the existing industries were not very inefficient. The lack of bankruptcies on a large scale in most liberalisation episodes except Chile would suggest that industries established during the protectionist period were not very inefficient and, given a few years to adjust, were able to meet international competition. The relationship between efficient industries and export performance may be even more tenuous, as was argued above. Even if a consumer industry in an LDC is efficient, if it is owned by a transnational the parent company might prefer to export from its home plants. For instance, the General Motors subsidiary in Korea, Daewoo, did not export, unlike the domestically owned firm Hyundai, despite the same policy environment. Exports of capital goods industries might also be constrained by the inability of LDCs to grant credit.

These studies do point to static inefficiencies arising from ISI policies, but a weakness has been to show how these state inefficiencies lead to slower growth.

#### 11.3.2.3 Trade Policy and Productivity Growth

Analysis of trade policy and productivity growth is designed to analyse the dynamic effects. But industry and firm level studies have found no evidence of faster growth of productivity in industries or firms in countries with outward oriented policies in contrast to countries with inward oriented policies (Rodrik). Studies also have found no evidence of faster productivity growth in export industries as compared to import substituting industries. Theoretical work by Rodrik and Allwyn Young also casts doubt on the notion that ISI policies are dynamically inefficient. The studies do not find a significant relation between trade policy and the savings rate. So slower growth can only be attributed to a higher capital output ratio. The capital output ratio was definitely higher in India in the sixties and early seventies than in East Asia. But the difference seems to have disappeared by the mid-seventies (Manmohan Agarwal, 2005).

**Check Your Progress 2**

1) What kind of research took place to analyse the link between trade policy and growth?

.......................................................................................................

.......................................................................................................

.......................................................................................................

.......................................................................................................

.......................................................................................................

2) Briefly explain the kind of research that was carried out to explain the relationship between export performance and growth.

.......................................................................................................

.......................................................................................................

.......................................................................................................

.......................................................................................................

.......................................................................................................

3) What is the relationship between trade policy, and efficiency? Discuss.

.....................................................................................................

.....................................................................................................

.....................................................................................................

.....................................................................................................

## 11.4 TRADE POLICY AND PERFORMANCE IN THE EIGHTIES AND NINETIES

This research together with the severe debt crisis in many developing countries in the eighties, and the general move towards market oriented policies in the developed countries starting in the late seventies resulted in a shift towards export oriented policies by more and more developing countries. Currently hardly any developing country has recourse to extensive QRs either because of BOP problems or because of developmental reasons. There have also been very substantial reductions in tariff rates in developing countries. Currently much of Latin America and the transition economies of Europe have average tariff rates of about 10 percent. Rates in East Asia, till the financial crisis of 1997, and South Asia are slightly higher. For instance, though average tariff rates in India have declined in the nineties from over 100 percent to about 20 percent and peak rates have declined from almost 400 percent to about 45 percent, they are still high compared to rates in Latin America and the transition economies.

The liberalisation of trade policies has resulted in a very rapid growth in exports and a large increase in the trade/GDP ratio in almost all regions of the world.

But the results in terms of growth have not been very encouraging. Low rates of growth continue to plague most countries in Latin America and Africa. As Bruton (1998) pointed out the reforms unfortunately ignored the very substantial achievements of the earlier period and instead of adjusting the policies to overcome their deficiencies they were totally discarded. The achievements of the earlier polices were substantial. Many developing countries raised savings and investment rates considerably higher than the 10 percent considered sufficient by economists such as Rostow and Lewis to generate a sustainable rate of growth, and grew faster than in any earlier period. Many countries also showed substantial improvement in social indicators such as education enrolments and literacy levels, reduction in mortality etc. The main drawback was an inadequate creation of jobs, the elasticity of employment creation turned out to be lower than had been expected. Consequently, poverty levels remained high. Also import substitution was undertaken haphazardly with practically all industries being granted protection. This resulted in waste. There is little justification for providing protection of over 350 % as was done in India. It is difficult to visualise what future improvements could justify so much inefficiency in the short run. Also merely removing protection is not enough. Positive policies have to be adopted to generate a supply response in export industries.

A major feature of the current state of the international economy is the increasing disintegration of the production process with different parts and components being produced in different countries. Preventing the free flow of intermediates and components by too high a tariff rate would result in inefficient production and inability to compete in the world market. But there is little evidence that free trade is the best policy. Relatively modest tariff rates of about 15 to 25 percent seem to be indicated.

## 11.5 GLOBALISATION: IS IT DESIRABLE?

The liberalisation of trade and capital markets has lead to a closer integration of the world market and new challenges in economic management. Opinion regarding globalisation is strongly divided. Many believe that globalisation hurts poorer groups and increases poverty and worsens income distribution. But many think that integration of countries into the world system is the solution to many of the problems plaguing these countries.

The main objections to globalisation can be divided into three broad groups. There is the fear that globalisation will hurt other objectives dear to the heart of the opponents of globalisation. A major fear that the opponents have is that globalisation is bad for poverty or for income distribution. It is usually expressed as that the poor become poorer after globalisation. In recent years there is also increased concern that globalisation is bad for the environment or, more recently, for women or labour standards more generally.

### 11.5.1 Globalisation, Poverty and Income Distribution

Most opponents rarely distinguish between poverty and income distribution and use the two terms almost interchangeably. But they are actually two different criteria. The additional income needed to lift a person above the poverty line is independent of how much additional income a rich person receives. Therefore, inequality could increase as the extent of poverty decreases and one's views about the desirability of globalisation and/or growth may depend on whether the criteria of poverty or income distribution is used. The effect of globalisation on poverty and income distribution can be broken into two separate questions. Firstly, what is the direct effect of globalisation on poverty or income distribution? Secondly, what is the indirect effect through growth, namely how does globalisation affect growth and how does growth affect poverty and income distribution?

### 11.5.2 Growth, Poverty and Income Distribution

The evidence on the effect of growth on poverty is very strong and suggests unequivocally that growth lowers poverty. While it is true that the extent of the impact of growth on poverty depends on the quality of growth, by itself growth tends to reduce poverty. Poverty reduction has been substantial in the countries of East Asia, which have experienced very high rates of growth. There was very little poverty reduction in India in the fifties and sixties when income grew slowly. The much higher growth rate in the eighties and nineties has resulted in a significant reduction in the extent of poverty—some estimates suggest that the extent of poverty has been almost halved. Furthermore, poverty reduction has been greatest in states that have grown faster. There is much less poverty in Punjab or Haryana. Poverty is concentrated in the Eastern states and in Bihar and U.P that have experienced little growth. Also poverty is concentrated among the tribal areas as these have been out of the economic mainstream. Growth is particularly important in poor countries or regions as the scope for redistribution under those conditions is limited.

The impact of growth on income distribution is much more controversial. Considerable research on the relationship between growth and income distribution has been undertaken since Kuznets first suggested the hypothesis that initially growth worsens income distribution and later improves it. The research has pointed out the complex interrelation between growth and income distribution and that this depends on the factor supplies available in the economy and the growth strategy adopted. For instance, when Korea initially adopted an export oriented development strategy the increased exports came from labour intensive industries such as textiles and apparel. Workers in these industries were either earlier unemployed or came from agriculture where their productivity was low. Thus in this phase of development, poverty levels decreased and income distribution became more equal. This experience contradicts the hypothesis that initially growth worsens income distribution.

Later the Korean economy shifted from exports of unskilled labour intensive goods to export of skilled labour intensive goods. Wages of skilled labour were considerably higher and so though poverty levels continued to decrease, the income distribution worsened. But it is not easy to see what policies could have been adopted to prevent the worsening of the income distribution. It would have been counterproductive to slow down the growth of the high wage sectors. It was also not possible to take unskilled workers away from their low paying jobs and train them to become skilled. Some were too old for this change and even others may not have been able to make the transformation.

The conclusion of the above analysis is that growth is almost always beneficial for the poorer classes and helps to reduce poverty. Its effect on income distribution depends on the growth strategy adopted and the factor supplies. Even where an overall increase in incomes is accompanied by a worsening of the income distribution it is not always easy to envisage policies that would prevent the worsening of the income distribution. However, experience in many countries suggests that the more equal the asset distribution the more equalising would growth be. In looking at assets one must include both physical assets and human assets. The main physical asset in a developing economy is usually land. But it is very difficult to redistribute land. It is easier to improve the distribution of human capital by providing broad access to education.

The above argument also shows that the direct effect of globalisation on growth depends on a country's comparative advantage and the resource endowments of the poor. For an overpopulated country such as India, China or Korea, globalisation, which allows the export and thus higher production of labour intensive goods, helps the poor. In a land abundant country and one where land is owned by large landlords, globalisation would worsen the income distributions though it may still lead to lower poverty by providing employment in farms, farm related activities or even provide non farm employment.

Openness very often leads to a reduction in poverty, but a worsening of the income distribution. This seems to be borne out by empirical experience as the public may have to decide which is more important. It just may not be possible to both reduce poverty and improve the income distribution. However, as suggested above policies, which improve the assets of workers, namely, education, would enable workers to reap larger benefits from globalisation. Also better education may enable the establishment of more skilled industries where workers would be paid more so that the income distribution may not be too adversely affected. Taiwan is an example of a country, which has managed to sustain a relatively egalitarian distribution of income throughout its development.

Trade liberalisation has also affected income distribution in the developed countries. The imports of cheap labour intensive goods from developing countries has reduced employment of unskilled labour in these countries, though the relative contribution of such imports as compared to technical change is controversial. The reduced demand for unskilled labour has resulted in the stagnation and even decline in their real wages. Meanwhile, the wages of the highly skilled workers have increased and the income distribution, particularly in the UK and US, has become much more skewed in the last quarter century. However, consumers have benefited from these cheaper imports. The availability of imports has contributed to low level of inflation in the advanced countries, which helps consumers, particularly poor consumers.

**Check Your Progress 3**

1) Give a brief account of the trade policy and performance in the eighties and nineties.

   ..........................................................................................................

   ..........................................................................................................

   ..........................................................................................................

   ..........................................................................................................

2) Income distribution depends on the growth strategy adopted and the factor supplies. Discuss.

   ..........................................................................................................

   ..........................................................................................................

   ..........................................................................................................

   ..........................................................................................................

   ..........................................................................................................

## 11.6 LET US SUM UP

In this Unit, you have learnt about the rationale for an Import Substitution Industrialisation Strategy. The Unit explains to you why Industrialisation was needed for developing countries? What strategy was adopted by the developing countries for their industrialisation? And what were the tools used for implementing an Import Substitution Industrialisation (ISI) strategy? The Unit exposes you to the research on trade policy in the mid-sixties. It explains the early experience with ISI and adjustments in policy. It also explores the research on trade policy and growth. The relationships explored are between export performance and growth of GDP; trade policy and efficiency; and openness and industrial productivity. The Unit then goes on to review the trade policy and performance in the eighties and nineties. Last but not the least, the Unit discusses globalisation in terms of its desirability and poverty and income distribution. While discussing this, it explores the relationship of growth, poverty and income distribution.

## 11.7 KEY WORDS

**Import Substituting Industrialisation** (ISI): It is a strategy for economic development based on replacing imports with domestic production.

**Openness Index**: It measures the extent to which an economy is open to trade, and sometimes also to inflows and outflows of international investment. It is the ratio of a country's trade (exports plus imports) to its GDP.

**Sachs-Warner Index:** Sachs-Warner index is a measure of the timing of liberalisation. It is based on five tests: (1) average tariff rates below 40 per cent; (2) average quota and licensing coverage of imports of less than 20 per cent; (3) a black market exchange premium of less than 20 per cent; (4) no extreme controls (taxes, quota and state monopolies) on exports; and (5) not considered a socialist country (Sachs and Warner 1997: 339). An economy is deemed to be open to trade if all five tests are satisfied. In principle of course, the Sachs-Warner index could be used to identify the *speed* as well as the timing of liberalisation, by observing how rapidly the five tests are satisfied.

**Spearman's Rank Correlation:** In statistics, Spearman's rank correlation coefficient, often denoted by the Greek letter ρ (rho), is a non-parametric measure of correlation. It describes the relationship between two variables, without making any assumptions about the frequency distribution of the variables.

**Trade Policy:** Trade policy is a policy that affects international trade. It includes especially tariffs and nontariff barriers.

**Trans National Corporation (TNC):** Same as multinational corporation. It is a corporation having its production units in many nations and whose national identity is a matter of convenience only. TNC normally moves its headquarters readily in response to incentives.

## 11.8 SOME USEFUL REFERENCES


Agarwal, M. 2005. The Evolving World Economy: Issues in International Economic Governance, paper presented at seminar in JNU.

Balassa, B. 1973. Exports and Growth, Further Evidence, *Journal of Development Economics* vol. 5.

Batchelor, R.A., R.L. Major and A.D. Morgan. 1980. *Industrialisation and the Basis for Trade*, Cambridge University Press.

Bhagwati, J.N. 1978. *Anatomy and Consequences of Exchange Control Regimes, Cambridge*: Ballinger Publishing Company.

Bruton, H. 1998. A Reconsideration of Import Substitution, *Journal of Economic Literature*, vol. 36(2).

Edwards, S. 1993. Openness, Trade Liberalisation and Growth in Developing Countries, *Journal of Economic Literature* vol. 31 (3).

Goncalves, R. and J. Richtering . 1986. *Exports Performance and Output Growth in Developing Countries*, Discussion Paper No.17, Geneva, UNCTAD.

Nurkse, R. 1953. *Problems of Capital Formation in Less Developed Countries*, Oxford: Blackwell.

Krueger, A . 1978. *Foreign Trade Regime and Economic Development: Liberalisation Attempts and Consequences*, Cambridge Mass, Ballinger Publications Co.

Rodrik. D. 1995. Trade and Industrial Policy in J.R.Behrman and T.N.Srinivasan, *Handbook in Development Economics* IIIB, pp. 2925-82, North Holland, Amsterdam.

Rodrik, D. and F. Rodriguez . 2001. Trade Policy and Economic Growth: A Skeptic's Guide to the Cross-National Evidence, in B. Bernanke and K.S. Rogoff, eds., *NBER Macro-economics annual 2000.*

Sheehey, E.J. 1980. Exports and Growth: A Flawed Framework, *Journal of Development Studies*, vol. 27.

Young, A. 1991. Learning by Doing: The Dynamic Effects of International Trade, *Quarterly Journal of Economics*, May.

## 11.9 ANSWERS/HINTS TO CHECK YOUR PROGRESS EXERCISES

**Check Your Progress 1**

1) Read Sub-section 11.2.1

2) Read Sub-section 11.2.2

3) Read Sub-section 11.2.3

**Check Your Progress 2**

1) Read Sub-section 11.3.2.

2) Read Sub-section 11.3.2.1

3) Read Sub-section 11.3.2.2

**Check Your Progress 3**

1) Read Section 11.4

2) Read Sub-section 11.5.2

# UNIT 12 TRADE IN PRIMARY COMMODITIES: ISSUES

**Structure**



## 12.0 OBJECTIVES

After reading this Unit, you will be able to

- learn the definition of the terms of trade;
- understand the behaviour of terms of trade; and
- discuss the reasons for terms of trade deterioration.

## 12.1 INTRODUCTION

Primary Commodity market issues have always been a centre of economic debate for economists. The arguments given have been around (1) the secularly declining terms of trade of primary commodities that have widened the gap between developed and developing countries. (2) they are considered as contributing factor to the creation of structural conditions of unequal exchange between a dominating industrial center and a dominated agrarian periphery. (3) they are often considered as source of instability.

The issue of the trends in terms of trade between primary commodities and manufactures has dominated the trade and development literature for many years. Since the time of Adam Smith it has been claimed that the terms of trade of primary commodities would be improving over time. It was not until the early 1950s when this argument was challenged radically by Prebisch and Singer who argued that the terms of trade of developing countries are bound to deteriorate progressively and inexorably as long as the present international economic order prevails.

In this Unit, we examine the behaviour of the terms of trade (TT) of primary products and various theories, which seek to explain the TT. Many different versions have been developed around the Central concept of the TT. The different versions reflect different interests that analysts have as they examine the results of North-South interaction. But the fundamental reason to be concerned about the TT is because it affects welfare.

## 12.2 DEFINITIONS OF THE TERMS OF TRADE

Since the development of the controversy in the 1950s, the concept of terms of trade is under careful scrutiny and several specifications and complementary to denote the ratios between the values of one commodity basket in terms of another. These values, however, can be defined, measured and aggregated in many ways.

To put it straight, in international trade, terms of trade are the ratio of the price of an export commodity(ies) to the price of an import commodity(ies). "Terms of trade" are sometimes used as a proxy for the relative social welfare of a country, but this is technically questionable and should be used with extreme caution. An improvement in a nation's terms of trade is good for that country because it has to pay less for the products it imports. In other words, it has to give up less exports for the imports it receives.

In a simplified case of two countries and two commodities, terms of trade is defined as the ratio of the price a country must receive for its export commodity to the price it pays for its import commodity. In this simple case the imports of one country are the exports of the other country. For example, if a country exports 200 dollars worth of export product in exchange for 100 dollars worth of imported product. The country's terms of trade are 200/100 = 2. The terms of trade for the other country must be the reciprocal (100/200 = .5). When this number is falling, the country is said to have "deteriorating terms of trade". If multiplied by 100, these calculations can be expressed as a percent (200% and 50% respectively). If a country's terms of trade fall from say 100% to 70% (from 1.0 to .7), it has experienced a 30% deterioration in its terms of trade.

In case of the terms of trade, there are number of concepts that alternatively emerge. These concepts fall into two groups: those that relate to exchange ratios between commodities and those that relate to exchange between productive resources.

1) The basic concept is that of the *Net Barter Terms of Trade (NBTT)*. This refers to the price of exports to the price of imports, namely $P_c/P_m = P$ where $P_c$ is the price of South's exports, and $P_m$ of its imports.

2) The *Single Factorial Terms of Trade (SFTT)* = $P.O_c$ where $O_c$ is output per person in the South. SFTT is the net barter terms of trade adjusted for the changes in productivity of exports. Then changes in SFTT measures the change in living standard of an exporter in terms of imports. Suppose productivity increases but price falls and the sum of the changes is zero, i.e., $\delta P+\delta O_c = 0$, then the SFTT index will be unchanged, namely, the living standard in terms of imports afforded by the exports is unchanged. But to the extent that the exported good is consumed at home, there is redistribution from producers to consumers. This gain is ignored by the definition of the SFTT. But this omission can be corrected. The Consumer Price index, CPI can be written as $P_c^{1-a}p_m^{a}$ where a is share of imports in the consumption basket. If E is money expenditure, then E/CPI is real expenditure when trade is balanced. So real expenditure is:

$$P_cQ_c \div P_c^{1-a}P_m^{a} = Q_c(P_c/P_m)^a = P^a.Q_c$$

So the real expenditure has increased as P has decreased. But if employment is constant, there is a one to one relation between an output index and a productivity index, and the index for real expenditure per employed person, $P^a.Q_c$, is the WSFTT or the weighted Single Factorial Terms of Trade.

DFTT *Double Factorial Terms of Trade* is adjusted for both the productivity of exports and productivity of imports. If the analyst is interested in the relative change in living standards, then the Double Factorial Terms of Trade (DFTT) is calculated.

DFTT = $(P_c/P_m)\,(O_c/O_m)$ where $O_m$ is output per person in the North.

This gives the relative value of the output of workers and combines relative prices and relative productivity.

Change in relative living standards can be decomposed into employment, productivity and TT changes. Suppose we keep employment out of the picture then the remaining two factors of productivity and TT can be combined into the DFTT. But the DFTT provides an accurate measure of changes in the relative size of consumption baskets only in special cases (i) fraction of income spent on tradeable goods should be the same in the two countries (ii) the relative price component is trendless.

For the DFTT, relative real income of the South relative to the North is $(E/P_c^{(1-a)} P_m^{a}) \div E^*/P_m^{(1-a)} P_c^{a}$ where E* is the expenditure in the North. When trade is balanced $E = P_cQ_c$ and $E^* = P_m Q^*_m$, and this expression becomes $(Q_c/Q_m^*)\, P^{a+a^*}$. Under constant employment assumption, this converts to k $P^{a+a^*}(O_c/O_m)$ where k is the constant ratio of persons employed in the two countries. k drops out when we view the last expression as an index. So

$$\text{WDFTT} = P^{a+a^*}\ (Oc/\ Om)$$

The trade unweighted version corresponds to the case where a+a* = 1. This condition is satisfied when the two countries have identical consumption patterns.

4) *Income TT* = $(P_c/P_m).\,O_c.N_c = V / P_m$

Where Nc is employment in the production of commodity, so that V is value of primary production.

The gives value of output measured in import prices. This is a useful measure as employment data to calculate Oc is often not available.

5) *Employment Corrected TT*: Since there is full employment in the North, increased output in one sector does not increase total income as income in other sectors declines. But this is not so in the South where because of unemployment output foregone elsewhere is zero. To take account of this, we can calculate the employment corrected DFTT namely ECDFTT which equals

$$\text{ECDFTT} = \left(\frac{P_c}{P_m}\right)\left(\frac{O_c}{O_m}\right)N_c = P^{a+a^*-1}V(P_mO_m)$$

Where V = PcOcNc is index of output of exportables valued at current prices.

This extends the index to all three dimensions and also gets rid of troublesome Oc, which can often not be calculated because of lack of data.

6) *Employment corrected WSFTT* is of interest to analysts again because of unemployment in the South.

$$\text{ECWSFTT} = P^aO_cN_c = \frac{P_c^a}{P_m^a}.O_c.N_c = \frac{P_c^a}{P_m^a}.P_cO_cN_c \ \ - \frac{P_c^{a-1}}{P_m^a}.\text{V}$$

The income terms of trade are $P O_c N_c$, namely, they correspond to the case where $a = 1$, and so equal P.X where X is quantity of exports, namely value of exports expressed in import prices.

If employment is not constant, then we calculate the ECWDFTT, employment corrected relative income double factor TT, $= P^{a+a^*} O (N_c/N)/O_m$.

**Check Your Progress 1**

1) What do you understand by terms of trade? What are its various forms?

....................................................................................................

....................................................................................................

....................................................................................................

2) Distinguish between a) single factorial terms of trade and b) double factorial terms of trade.

....................................................................................................

....................................................................................................

....................................................................................................

3) Distinguish between income and employment corrected terms of trade.

....................................................................................................

....................................................................................................

....................................................................................................

## 12.3 THE BEHAVIOUR OF THE TT

The likely evolution of the TT, a feature of classical analysis, was resurrected in a development context by Prebisch. In classical economics scarcity of land would lead to an increase in primary prices and the terms of trade for primary products would improve. This would make further industrial investment unprofitable and economic growth would grind to a halt and the economy would reach the stationary state. In more recent times, this line of argument has been adopted by various environmentalists starting with the Club of Rome analysis.

Prebisch argued that developing countries could not adopt a development strategy based on growth of the agricultural sector and export of the resulting higher output. Any attempt to raise the growth rate of an economy would require a higher investment ratio and larger imports of capital goods since developing countries do not have a large domestic capacity to produce capital goods. But export earnings would grow only slowly because terms of trade would decline as more agricultural goods were exported. Consequently, export earnings would be insufficient to finance the imports of capital goods, leading to BOP problems, and so attempts to raise the growth rate would be nulliflied.

Prebisch provided a detailed statistical analysis for his contention that the terms of trade of developing countries were deteriorating. He could not find data for the terms of trade of developing countries, so he calculated the TT of the UK. Since the UK was mainly an exporter of manufactures and an importer of

Prebisch found that the TT of the UK had improved between 1870 and 1938 and therefore concluded that the TT of developing countries had deteriorated.

This procedure adopted by Prebisch was criticised on several grounds.

1) It was not valid to use the inverse of the UK's TT as representing the TT of developing countries, because the UK's NBTT was not representative of industrial countries as a whole.

2) Furthermore, the UK imported primary commodities from developed countries, and prices of primary commodities from developed countries could have declined while prices of primary commodities from developing countries could have increased.

3) Exports are valued on a f.o.b. basis and imports on a c.i.f. basis. Then prices of imports into the UK may have declined because of a fall in shipping costs since import prices include freight charges. But then the fall in import prices in the UK could occur without a fall in the prices of commodities exported by developing countries. So the UK's TT could improve without worsening the terms of trade of LDCs.

4) The usual method of calculation of price indices doesn't take account of introduction of new goods and quality differences. Both apply mainly to manufactures, thereby biasing the results.

Apart from these criticisms of Prebisch's historical analysis, economists found no evidence to support the case for a deterioration in the TT in the immediate post Second World War decades.

Let us first examine the criticism that the TT of the UK was not representative of developed countries as a whole. After painstaking analysis Sparos concluded (p.53), 'the leap from the evidence of Britain's NBTT to an inference about the relative price of primary products vis-a-vis manufactures in world-wide trade was not misleading as to direction though it gave an exaggerated impression of the magnitude of the deterioration'. We now examine the bias from not distinguishing between primary exports of developed and developing countries. An analysis of the TT of the US, which imported mainly tropical products and exported other primary commodities improved during this period. Also, an analysis of the TT for agricultural products in European trade, namely, the prices of agricultural products exported by European countries relative to prices of agricultural products imported by European countries, found that these had improved.

Both these pieces of evidence show that the prices of agricultural products exported by developed countries increased. This strengthens the argument that if the relative prices of primary products imported into the UK were falling this would be because of a decline in prices of primary goods imported from developing countries.

The evidence also does not support the contention that freight rates fell more sharply than prices of agricultural products except in the period 1900-08, and thus could not have caused an improvement in UK's TT without causing a deterioration in TT of developing countries.

Spraos also argues that there is no reason to suppose that quality improvement primary products. Consumers, for instance, could move from an inferior brand of tea to a superior brand, which commands a higher price. Such a movement would show up in the data as an improvement in the terms of trade. Also, in later years, more processing of primary products occurs in developing countries before the products are exported. Such processing may not lead to a change in the classification of commodities as primary, and would again appear as an improvement in the TT. Furthermore, price indices that try to account for quality changes have been developed for later years. Analysis of these indices does not show any significant trend TT difference between indices that incorporate quality changes from those that do not.

Spraos tried to improve on the indices calculated by Prebisch. Splicing together various import and export indices and also taking into account changes in transport costs, he finds that the basic conclusion of Prebisch - a decline in the TT of primary commodities - is sustained even though the rate of decline is somewhat slower than what Prebisch had estimated.

The problem with analysing TT changes in the post Second World War period is that the results depend very much on the period chosen for the analysis. In the immediate decades after the Second World War till 1973, the world economy grew rapidly and demand for primary commodities was buoyant. Though prices of primary commodities fluctuated considerably, there was no prolonged decline in real commodity prices. Fluctuations in the prices of primary commodities have also been an issue of considerable concern to developing countries. It was a major item on the agenda on the negotiations for a new International Economic Order in the 1970s. The developed countries finally accepted the demand of developing countries for a fund to stabilise prices. But the agreement was still born as the size of the Fund was too small to be effective, and it was never made operational. But the picture changed dramatically after the sharp rise in oil prices in 1973-74. Growth of the world economy, except of economies in Asia, slowed considerably with a devastating effect on primary prices. Grilli and Yang (1988) show that the prices of non-oil primary commodities have declined relative to the prices of manufactures by about 0.6% a year during the period 1900-1986, continuing the decline observed by Prebisch, though at a slower rate.

The prices of primary commodities declined particularly sharply in the 1980s. The decline continued in the 1990s though at a slower rate. But in the 1990s energy related prices, i.e., of oil, gas and coal, slowed a tendency to increase. In more recent years, prices of metals have also increased because of demand from China.

Grilli and Yang, however, found that the terms of trade of developing countries did not deteriorate much despite the fall in primary commodity prices because developing countries had diversified their export baskets. The TT of developing countries would have deteriorated much more sharply if their development strategy had been based on growth of the agricultural sector, as feared by Prebisch.

## 12.4 A FALLACIOUS ARGUMENT FOR TT DETERIORATION

It is often argued that increases in labour productivity in the North are reflected

LDCs they result in lower prices as primary goods markets are perfectly competitive. So as productivity increases constantly, the net barter terms of trade (NBTT) of primary products would deteriorate constantly.

But this conclusion does not follow so simply or as stated. The NBTT is a ratio of two money prices. Fixing one will cause the other to adjust to it at the market clearing relative price. It, therefore, doesn't follow that fixing one price necessarily implies a deterioration in the terms of trade.

To see this, we develop a simple model. We assume two regions each specialised in production of one good. There is constant employment in each region and labour immobility between nations, and costless technical progress. We assume equal productivity growth in both regions, and unit income elasticity of demand for both products. We also assume wages are proportional to value added per worker so that the share of wages in national income is constant. We also assume macroeconomic equilibrium.

Suppose there is constant productivity growth in both primary commodities, C, and manufactures, M. Suppose NBTT ( $P = P_c/P_m)^x$ is at the market clearing value. Now because of technical change, the output of both C and M will increase by the same proportion and, therefore, so will world income. Since income elasticities of demand are all unity, demand for C and M will also increase by the same proportion and the market for both will just clear at the previous relative price. The unchanged relative price is sustainable and there is obviously no deterioration of the NBTT (see Figure 12.1).

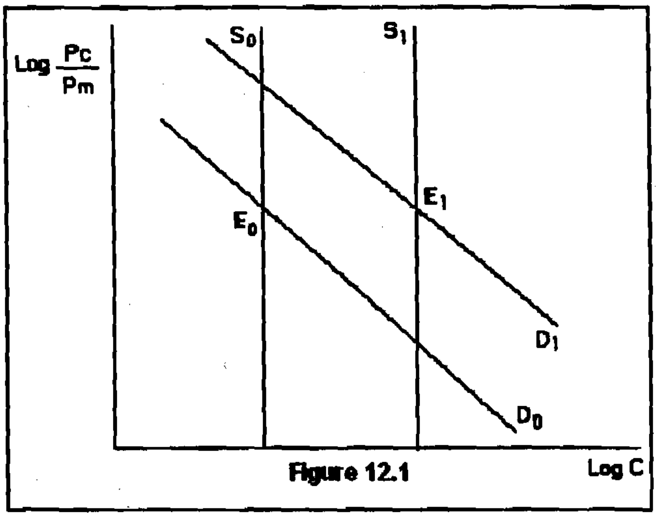


Figure 12.1

Figure 12.1: Shows that $E_1$ is new equilibrium when there is equal productivity change in C&M, and elasticity of demand is 1.

If elasticity of D for C<1, then shift in D will be less and equilibrium price will be lower then at Eo.

If productivity growth in commodities is less, then shift in S is less and equilibrium price is higher.

Suppose response is asymmetrical along Prebisch-Singer lines. In the North, money wages rise in proportion to productivity in manufactures so that Pm does not change. But Pc falls by the same percentage as increase in productivity. The NBTT have deteriorated. But the market will not clear. There is excess supply of manufactures and excess demand for commodities as price of commodities has fallen and that of manufactures risen relatively. One solution is for manufacturing output and employment to fall. In this case, fall in NBTT will persist. But this is not proposed as a serious scenario. Another is for the increase in productivity to raise output of primary commodities, a case we examine later. The only other plausible market clearing mechanism is for Pc to rise as Pm cannot change, and it will keep on rising till the earlier NBTT is restored.

The original NBTT depended on a particular degree of monopoly power in manufacturing. As long as the degree of monopoly power does not change, there will be no effect on NBTT. And there is no plausible reason to assume a continuously increasing monopoly power in manufactures.

**Check Your Progress 2**

1) Why the analysis given by Prebisch was criticised? Discuss.

.....................................................................................................

.....................................................................................................

.....................................................................................................

2) What was the fallacious argument given in favour of TT deterioration?

.....................................................................................................

.....................................................................................................

.....................................................................................................

## 12.5 LET US SUM UP

The empirical evidence shows clearly that there has been a tendency for the NBTT to deteriorate over the past century and a quarter.

The developing countries had sought till the 70s the establishment of measures to stabilise prices of commodities. But they have been unsuccessful in this endeavour. The developed countries have been reluctant to do this at the international level. They have, however, adopted various measures to stabilise domestic prices with adverse effects on the trade of many developing countries. Multilateral trade negotiations may force developed countries to change their policies. But it is unlikely that this will lead them to support international price stabilisation efforts.

It has also proved difficult to continue with the commodity funds that have been established. It has been difficult to distinguish price fluctuations from the secular decline in the NBTT. As a consequence, prices have been sought to be stabilised at too high a price leading to greater excess supply and forcing the fund to buy more and more quantities till the policies become unsustainable and collapsed. Developing countries must recognise that stabilisation does not mean that prices of commodities will remain constant.

The decline in the TT has been particularly disastrous for the least developed countries who depend heavily on the exports of primary products. Developing countries have sought to diversify their export basket, but most have not succeeded. This experience needs careful analysis so that better policies for export diversification can be adopted and developing countries can move out of the trap of deteriorating terms of trade for primary commodities.

## 12.6 KEY WORDS

**Double Factorial Terms of Trade:** It is net barter terms os trade adjusted for both the productivity of exports and the productivity of imports.

**Gross Barter Terms of Trade:** It is the ratio (expressed as a percent) of a quantity index of exports to a quantity index of imports.

**Income Terms of Trade:** It is the ratio (expressed as a percentage) of the value of exports to the price of imports.

**Net Barter Terms of Trade:** It is the ratio (expressed as a percentage) of relative export and import prices when volume is held constant.

**Single Factorial Terms of Trade:** It is the net barter terms of trade adjusted for changes in the productivity of exports.

## 12.7 SOME USEFUL REFERENCES


Diakosavvas D. and Scandizzo P. L. 1991. 'Trends in the Terms of Trade of Primary Commodities, 1900-1982: The Controversy and Its Origins'. *Economic Development and Cultural Change.* vol. 39, no. 2 (Jan.). pp. 231-264

Grilli E.R. and Wang, M.C. 1988. 'Primary Goods Prices, Manufactured Goods Prices, and the Terms of Trade of Developing Countries'. *World Bank Economic Review.* vol 2, pp. 1-47.

Hadass Y.S. and Williamson J. G, 2003. 'Terms of Trade Shocks and Economic Performance, 1870-1940: Prebisch and Singer Revisited'. *Economic Development and Cultural Change.* vol. 51, no. 3, pp.629-56.

Krueger, A. and Sonnenschein, H. 1967. The Terms of Trade, The Gains from Trade, and Price Divergence. *International Economic Review,* vol 8, no.1, February, 1967, pp. 121-127.

Singer Sir Hans, Hatti N. and Tandon R (eds.). 2002. *Export-Led Versus Balanced Growth in the 1990s.* Reprint. B.R. Publishing. Delhi.

Spraos, J. 1980. 'The Statistical Debate on the Net Barter Terms of Trade of Trade Between Primary Products and Manufactures'. *Economic Journal,* vol. 90.

Spraos, J. 1983. *Inequalizing Trade: A Study of Traditional North/South Specialisation in the Context of Terms of Trade Concepts.* Clarendon Press, Oxford.


## 12.8 ANSWERS/HINTS TO CHECK YOUR PROGRESS EXERCISES

**Check Your Progress 1**

1) Read Section 12.2

2) Read Section 12.2

**Check Your Progress 2**

1) Read Section 12.3

2) Read Section 12.4

# UNIT 13 ISSUES ON TRADE IN SERVICES

**Structure**



## 13.0 OBJECTIVES

After reading this Unit, you will be able to

- appreciate the growing importance of services in the trade;
- discuss the consequences of inclusion of services in multilateral trade negotiations;
- learn the outcome of negotiation on services;
- know the service negotiations since Uruguay Round; and
- argue the case of India and trade in services.

## 13.1 INTRODUCTION

The structure of the developed economies has been changing significantly over the past few decades. The manufacturing sector has been shrinking and the services sector has been growing in importance. The expansion of the services sector is partly because of the development of new services but also because more services are incorporated into goods sold, as it makes them more suited to individual consumers and it makes their consumption more convenient. For instance, development of Automated Teller Machines (ATMs) and internet banking has made banking more convenient. The importance of the services sector has also grown in developing countries though at a slower pace. Furthermore, at the same time, the importance of the manufacturing sector has been growing in many developing countries.

The change in the production structure is reflected in trade patterns. Developing countries have increased their share of exports of goods, particularly manufactured goods. But developed countries have increased their share of exports of services, particularly commercial services. The share of all developing regions, except Asia in exports of commercial services has declined over the past decade. Developed countries, particularly the US, were therefore keen to bring trade in services within the ambit of the international trading system. But negotiations on services have been more difficult and have had a more profound effect on the nature of economic negotiations than negotiations on trade in goods.

## 13.2 GROWING IMPORTANCE OF SERVICES

### 13.2.1 Structure of Production

Chenery and his colleagues have analysed how the structure of production changes as per capita income rises (1975). They observed that at the initial stages of development the share of manufactures in GDP rises. At a still higher level of per capita income the share of services rises. Developed countries show this pattern (see Table 13.1). The share of manufactures has decreased particularly rapidly in recent years, and this has generated considerable controversy. Economists in the developed countries have analysed this phenomenon, which they have called de-industrialisation. Some economists have charged that increasing competition from producers in developing countries has resulted in the shrinking of the manufacturing sector, particularly the labour intensive sectors, which have faced fierce competition, fostered in part by the reduction in tariffs on manufactures in previous Rounds of multilateral trade negotiations (MTNs). For instance, the average import duty levied by developed countries on manufactures was about 6% in the eighties, though this masks the fact that duties on goods imported from developing countries were much higher. Other economists have, however, argued that the shrinking of employment in the manufacturing sector has been because of technological change, which has been labour saving (Bhagwati & Kosters, 1994).

**Table 13.1: Structure of Production (%)**

| | Agriculture | | | Industry | | | Manufacturing | | | Services | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1960 | 1980 | 1995 | 1960 | 1980 | 1995 | 1960 | 1980 | 1995 | 1960 | 1980 | 1995 |
| Low Income | 50 | 35 | 25 | 17 | 26 | 38 | 11 | 15 | 27 | 33 | 38 | 35 |
| Middle Income | 22 | 15 | 11 | 31 | 45 | 35 | 22 | 23 | 18 | 47 | 40 | 52 |
| High Income | 6 | 3 | 2 | 40 | 36 | 32 | 30 | 24 | 21 | 54 | 61 | 66 |

However, there is little dispute that technological change has changed the nature of services. As Bhagwati (1984) notes, in earlier times a musical performance was usually a non–tradeable service, and only people from the area around where the performance was staged could attend it. Subsequently, when music could be captured on records and tapes, a musical performance became tradable through the medium of a good. Still later with the advent of radio and TV the service could be traded without necessarily trading the medium products such as radios and TVs. The service itself had become tradable and did not have to be embodied in a good. Technical change has made many services tradable without these being embodied. Furthermore, as noted earlier, the service component attached to a good that is sold has increased to make the good more accessible and convenient to consumers.

Services comprise 60% of world GDP and provide 50% of the employment. The share of services has been rising in the 90s in all regions of the world. Of course, it may be that some of the increase in services in developing countries is of low productivity services, and reflects the prevalence of high levels of unemployment and under-employment.

## 13.3 CONSEQUENCES OF INCLUSION OF SERVICES IN MULTILATERAL TRADE NEGOTIATIONS

The proposal by the US in 1982 to include services in multilateral trade negotiations (MTNs) had profound effects on the nature of MTNs and the position of less developed countries (LDCs). The proposal was initially met with hostility by developing countries, particularly the High Level Informal Group, which included India and Brazil (Narlikar, 2003). The Europeans also reached cautiously as nobody was sure about the true picture regarding services trade and what the negotiations might entail.

Gradually, the issue of inclusion of services brought about a schism among the developing countries. While India and Brazil and some other countries remained opposed to the inclusion of services, others such as Colombia, South Korea, Jamaica, etc. become more open to the idea of inclusion or at least to an examination of the issues involved in services trade. They formed an informal group, which included some developed countries to examine the issue of services trade.

Motives for this change varied among developing countries. Some, particularly the East and South East Asian countries, thought that they might have a comparative advantage in some services. Others wished liberalisation in other areas and believed that without some progress in services, trade in their preferred products would not be liberalised. Gradually this group gained importance. Ultimately countries like Brazil and India were not able to keep services out of the negotiating agenda that was decided at Punte del Este, Uruguay in 1986. But they thought that they had managed to keep service negotiations separate. There was a negotiating group for services separate from the other negotiating groups. This separation was to prevent cross sector retaliation. If a country did not fulfil its commitments in the services area then a partner country could not take retaliatory action on its exports of goods. So retaliation would be restricted to the country's service exports. Since developing countries did not export much of services, only limited retaliation could be carried out against their exports. However, the final Uruguay Round agreements allowed such cross-sector retaliation.

**Check Your Progress 1**

1) What were the reasons behind the growing importance of services in trade?

..........................................................................................................

..........................................................................................................

..........................................................................................................

..........................................................................................................

2) What are the consequences of growing importance of services in trade?

..........................................................................................................

..........................................................................................................

..........................................................................................................

..........................................................................................................

## 13.4 OUTCOME OF THE NEGOTIATIONS ON SERVICES

Negotiation about trade in services proved to be very complex. Trade in goods is easily identifiable and controllable. Goods exported from one country to another cross the border into the importing country at some point. At this border point trade is controlled by tariffs or licenses or other trade policy measures as you have read in Unit 4, Block 2. It can also be judged whether the product meets the country's health and safety standards.

But this is not the case with services (Sampson and Snape, 1985). Trade in service can take different forms. As you have read in Unit 5, section 5.3, Block 2; there are principally four modes of providing services to foreigners and these are defined in the General Agreement in Trade in Services (GATS) as -

1) **Cross-Border Supply:** From the territory of one member into the territory of any other member. For instance a doctor located in India could provide medical services to patients in the US by consultations over the phone or through the internet.

2) **Movement of Consumer:** Supply of the service in the territory of one member to the consumer of any other member. For instance, when a foreign patient comes to India for medical treatment.

3) **Commercial Presence:** By a service supplier of one member, through the commercial presence in the territory of any other member. An Indian company could establish a hospital in the US to provide medical services. The people working in the hospital could be US citizens.

4) **The Right of Natural Persons to Travel:** By a service supplier of one member through presence of natural persons of the member in the territory of any other member. Indian doctors could travel to the US to provide medical services.

Technology may determine in which mode a service is delivered. Till a few years ago medical services could not be provided across borders. But today they can be provided, though imperfectly, over the internet. Another example is outsourcing. Today these services are provided across borders without an Indian company establishing branches abroad or Indian people moving abroad. But till a few years ago this could not have been done.

Now it is clear from the examples that trade in services are controlled by domestic laws. For instance, recall the attempts by some state legislatures and even Congress in the US to prevent outsourcing of government contracts. Domestic laws govern the qualifications of doctors or regulations that hospitals have to follow. Whether foreign consumers can come to India for medical treatment may depend on whether the patient's insurance company will pay for such treatment. This, in turn, may depend on the regulations governing operations of insurance companies. If a country allows entry of foreign doctors it has to decide whether to accept foreign degrees or subject them to additional tests or requirements. While this may be relatively easy to do if the doctor comes to the country it might be very difficult to do if the medical services are provided over the internet. Since trade in services is controlled by domestic laws and regulations; laws may need to be changed with liberalisation and as technology changes.

No country, whether developed or developing, was willing to envisage a complete overhaul of its laws and regulations. Consequently, the agreement was reached on the basic principles that should govern trade in services. It was envisaged in the Agreement that the same principles of Most Favoured Nation (MFN) and National Treatment (NT), subject to some limitations, should apply to trade in services as they applied to trade in goods. However, unlike in the case of goods, MFN and NT are not unconditional. Countries can specify exceptions to these in their offers and in the agreements reached. Since trade in services is more governed by laws and regulations, all members are required to publish all measures, which govern supply of a service, which it has agreed to liberalise. It is also required to inform the WTO's Council for Trade in Services of these measures. Each member has also to establish one or more enquiry points to provide specific information to other members upon request. Also, where specific commitments have been made, members should prescribe procedures and bodies to review complaints and to provide appropriate remedies where necessary. As can be immediately seen, these affect domestic procedures, regulations and laws.

GATS also followed a different approach regarding which services would be liberalised. The agreement on services followed the positive list approach rather than the negative list approach followed in case of goods. A country had to 'offer' a particular service for liberalisation. It could also choose the mode of delivery for which the trade was liberalised. For instance, no country has made significant offers under mode 4, namely, movement of natural persons, as a country wants to be able to control which persons can enter its territory. A country could also 'request' another country to liberalise particular service sectors. This is called the 'request/offer' negotiation procedure.

Because of the difficulties little progress was made in actual liberalisation beyond agreement on principles. However, some progress has been made. Most developed countries have made sectoral commitments in more than 70 sectors, while the US, the EU, Japan and some other countries made commitments in more than 100 sectors. However, developing countries made commitments in only 16 sectors (Altinger and Enders, 1996).

However, these numbers give an exaggerated view of the extent of liberalisation. Australia has made commitments in more than 80 sectors, but it was estimated that only about 20-25 per cent of its total production of service was covered by these liberalisation commitments. Most countries made commitments in sectors and by modes that were already open and resisted opening more sectors. No commitments were made by any member, which would have called for changes in legislation and regulations. However, ever these commitments represent progress as they are bound. You have read about bound rate in Unit 5, Block 2.

Negotiations in two sectors, financial and telecommunications services, were left at an unsatisfactory state at the conclusion of the UR negotiations. The financial services negotiations ended in July 1995 with an interim agreement. But the US was unhappy and essentially withdrew its offer unless other countries improved their offers. Out of total 76 countries, 29 made commitments and improved their offers so that the interim agreement came into force. Later, after further negotiations, a financial sector agreement was reached in 1997. But developing countries had made only limited commitments.

Negotiations on telecommunications services were extended, but were suspended for a period after the US claimed that only 10 out of the 34 offers received were acceptable. The US was concerned that the offers of others allowed the domestic monopoly supplier in the partner country to exploit the competitive conditions in the US to secure monopoly returns on the traffic between the US and its own country. But agreement was finally reached in early 1997 among 69 countries and covered about 90 % of the basic telecommunications services of the members.

The negotiations on trade in services, however, had profound effects on developing countries. First developing countries recognised that unless they participated in the negotiations rules might be agreed upon, which were detrimental to their interests. Many developing countries, which had earlier not been members of the GATT started the process of negotiations to become members. This resulted in a large increase in the membership of GATT, and since 1995, the WTO. This has changed the character of negotiations as we discuss in greater detail below.

The negotiations during the UR had split the developing countries. In both the cases of agriculture and services, mixed coalitions of developed and developing countries seemed to be more effective. Towards the end of the UR negotiations, this conclusion was questioned. Since then further doubts have arisen about the efficacy of mixed coalitions (Agarwal, 2005).

Till the UR, developing countries had played only a limited role in the negotiations. Very often decisions were reached by a few of the key players, usually the developed countries, and then presented to the developing countries as an agreed position. For some reason, developing countries did not object to this procedure, though GATT agreements were supposedly reached by consensus.

The increasing membership by developing countries has resulted in their objecting to such an undemocratic procedure and refusal to accept decisions reached in this manner. Thus developing countries including India are now playing a much more meaningful role in negotiations. You will read about the role of India in negotiations in Unit 19, Block 6.

## 13.5 SERVICE NEGOTIATIONS SINCE THE UR

As noted above, some service negotiations were extended beyond the UR agreements, and agreement in these sectors was reached later. The UR agreement itself mandated farther negotiations on liberalisation of service trade to start in 2000. The ministers at Doha essentially endorsed the agenda that had been agreed upon earlier by the Council for Trade in Services. Most of the procedures and technical guidelines had already been agreed upon as also the scheduling of commitments. Participants were to submit their initial requests by 30 June 2002 and initial offers by 31 March 2003. The Cancun ministerial reiterated these time lines. But compliance with this time-table has been poor.

Initially, 69 offers covering 52 members were received. Later, 28 offers covering 52 members were revised. An analysis shows that most offers are in modes 1-3. Even where offers are made in mode 4 they are usually tied to commercial presence. Only 3% of offers cover independent professionals. There are also significant limitations on foreign equity participation and on the number of suppliers permitted entry, or the type, namely the legal structure of the entity.

Dissatisfaction with the progress of negotiations has resulted in a re-examination of the request/offer method adopted for trade liberalisation in services. Accordingly, the Hong Kong Ministerial in 2005 allowed the request offer negotiations to be conducted in a plurilateral manner (allowing joint requests by groups of countries) in addition to the bilateral process that had been adopted till then. The ministerial also set a revised time-table. Any outstanding initial offers should be submitted as soon as possible. Initial Plurilateral offers should be made by 28 February 2006 or soon thereafter. A second round of revised offers shall be submitted by 31st July 2006, and the final draft schedules of commitments by 31st October 2006.

Substantively, the Hong Kong Ministerial agreed that in modes 1 and 2, commitments should be made at existing levels of market access on a non-discriminatory basis across sectors of interest to members. Also mode 1 access should not require commercial presence. Therefore, requirement of commercial presence should be removed from offers of liberalisation under mode 1. It is further stated that where commitments exist under mode 1, commitments under mode 2 should also be made.

Commitments under mode 3 should be made more liberal by allowing for enhanced levels of foreign equity participation, removal or substantial reduction of economic needs tests and allow greater flexibility on the types of legal entity permitted. Similarly, members are encouraged to improve their offers under mode 4: allow greater scope for contractual services suppliers, independent professionals and others de-linked from commercial presence, increase duration of stay and remove or substantially reduce economic needs tests.

The negotiating document agreed to at the Hong Kong ministerial had been unilaterally put forward by the Chairman of the Negotiating Group on Services despite the strong opposition of developing countries (M. Dubey). The plurilateral approach accepted in this document will lead to greater liberalisation in developing countries as they will find it difficult to face the joint pressure from several powerful countries. Liberalisation will also be speeded up by the acceptance for consideration of 'sectoral and modal approaches' to negotiations as under this countries would be required to open up a minimum number of sectors and to agree to a minimum extent of opening across sectors.

**Check Your Progress 2**

1) How many Modes of providing services are discussed under GATS?

......................................................................................................................

......................................................................................................................

......................................................................................................................

.........................................................................................................

2) Give a brief account of the service negotiations under UR (Uruguay Round).

.........................................................................................................

.........................................................................................................

.........................................................................................................

.........................................................................................................

## 13.6 INDIA AND TRADE IN SERVICES

India had objected to the inclusion of trade in services in the agreement for the UR negotiations. The Indian negotiations continued to raise objections to libralisation in the subsequent negotiations. Few could have anticipated that trade in services would be the dynamic sector in Indian export performance.

Trade in services has been dynamic growing at 6 per cent a year between 1990 and 2002. Undoubtedly, the developed countries have comparative advantages as they have the lion's share of exports of commercial services (Table 13.2). Furthermore their share in commercial services is higher than their share in goods exports. However, developing countries, both low income and middle-income countries, increased their share of commercial services exports between 1990 and 2002. But this better performance of developing countries as a whole, hides the uncomfortable fact that this is mainly because of the performance of the Asian countries. The share of other developing country regions in exports of commercial services has declined (Table 13.3).

**Table 13.2: Regional Share in Exports of Goods and of Services, 2001**

| Countries | Goods | Services |
|---|---|---|
| North America | 16.6 | 20.5 |
| Western Europe | 41.5 | 46.5 |
| Japan | 6.7 | 4.4 |
| East Europe | 4.8 | 3.8 |
| LDCs | 30.5 | 24.8 |
| Latin America | 5.8 | 4.0 |
| Africa | 2.4 | 2.1 |
| M.East | 4.0 | 2.3 |
| Asia | 18.3 | 16.4 |
| India | 0.7 | 1.4 |

Source: WTO (2002)

But when commercial services are broken into transport, travel and other services such as banking, insurance, professional, data related, consumption etc., developing countries have made a substantial gain in travel services. All regions except Latin America have increased their share. Small gains have also been made by developing countries in both transport and other services.

But whereas only East Asia increased its share in transport services, all regions, except SSA(Sub Saharan Africa), increased their share of other services. So developing countries are doing well in the dynamic services as exports of travel services increased at an annual rate of 5.6% and other services at 7.0%, whereas exports of transport services grew annually at only

1.1%. But developing countries started off with a relatively low share of the dynamic "other services" sector.



**Table 13.3: Regional Shares in Exports of Commercial Services and Growth of Exports**

| Transport | Travel | Other | 1990 Total | | 2001 Total | Transport | Travel | Other |
|---|---|---|---|---|---|---|---|---|
| 1.7 | 2.1 | 1.9 | 1.9 | Low | 2.7 | 1.2 | 2.7 | 2.9 |
| 10.8 | 13.9 | 7.8 | 10.5 | Middle | 14.4 | 12.8 | 21.6 | 10.1 |
| 87.5 | 84.9 | 90.3 | 87.6 | High Income | 82.9 | 85.0 | 75.7 | 87.0 |
| 2.7 | 4.2 | 2.0 | 2.9 | EAP | 5.0 | 3.2 | 8.4 | 3.5 |
| 3.4 | 5.3 | 1.9 | 0.9 | SA | 1.6 | 2.9 | 5.2 | 2.2 |
| 2.4 | 2.4 | 1.4 | 1.9 | MNA | 1.6 | 1.7 | 2.7 | 0.8 |
| 0.9 | 0.8 | 1.0 | 1.3 | SSA | 0.9 | 0.8 | 1.0 | 2.6 |
| 1.4 | 1.4 | 1.0 | 3.3 | LAC | 3.3 | 0.9 | 1.5 | 0.4 |
| 0.4 | 0.6 | 0.7 | 0.6 | India | 1.6 | 0.6 | 0.8 | 2.2 |

Source: World Bank (2004)

India has increased its share of all types of services, and particularly of other services. India's share of exports of services at 1.4% is double its share of world exports of goods. Furthermore, its share of the "other services" sector is even higher at 2.2%. This points to the dangers of negotiating without adequate analysis, though one should not be too harsh on the Indian negotiators as little was known about services trade and the technological leap in IT was difficult to predict.

The success of Indian service exports in the past decade points to the difficulties in anticipating the benefits from liberalisation. Analysis is made more difficult in the case of services (J.Whalley, 2003) by the difficulties of defining services, measuring service trade and indicators of barriers to trade. Services can range from purely intermediate goods, such as some back office operations, to those that are partly intermediate and partly final consumer goods, e.g., banking and telecommunications, to those that are basically final consumer goods e.g., tourism. Lumping them together as services suggests that the analysis may be seriously flawed. Data on the level and composition of international trade in services is poor because there is no formal customs clearance for services trade. Barriers to trade are sometimes measured by price differences and sometimes by frequency data showing prevalence of regulatory measures etc. But there are problems with all such measures. For instance, regulatory measures may or may not be barriers to trade. Such conceptual differences make difficult estimation of the benefits from liberalisation. They also make the task of negotiations difficult.

India has demonstrated its competitiveness in a wide variety of services. In the UR, Indian negotiators had to concentrate on getting concessions on the mode 4 form of trade in services namely movement of natural persons. Most of us remember the issue of H visas for Indian IT workers. A few years ago the US had increased the number of such visas issued. But in the subsequent year, the number of such visas issued had declined substantially. A WTO agreement on movement of natural persons would prevent such large fluctuations. However, visas are not the only problems. Germany had also liberalised the issuance of visas. But Indian workers were much less enthusiastic about this liberalisation and the number of the people availing of the facility was much smaller than the number of visas available as the overall atmosphere in Germany was perceived to be hostile to such workers. In the Doha Round, Indian negotiators are seeking liberalisation of both mode 1 and mode 4 delivery of services.

The success in exports of services has changed the negotiating position of India, which now reflects the belief that India can gain considerably from access to western markets. Also as prospects for progress under mode 4 seem limited, India has sought to widen the net to provision of services under other modes. Experience also shows that India has not only an interest in mode 4 services, but also services provided for by other modes. But it should be remembered that we would have to also liberalise import of services and so liberalisation under mode 4 would imply allowing foreign nationals into India. The negotiating position has to be carefully crafted.

Mode 1 has become very important with the expansion of various forms of back office services whether call centres, various billing, and transcription services etc. This is likely to grow very rapidly. In mode 2, we have an expanding inflow of foreign students to attend our colleges and universities and foreign patients coming for treatment. The most prominent form of mode 3 in current circumstances would be the establishment of foreign banks and providers of other financial services, which hire, for instance, many economists. Mode 4, at the moment is very limited in India.

Two of the area where India is willing to liberalise and which have become controversial are distribution and higher education. We discuss them briefly.

Only 36 countries made commitments during the UR in the area of distribution and even these were of a limited nature. Negotiators seemed to have only limited interest in this sector. But in the Doha Round of negotiations, it has become more prominent and, in particular, the EU and the US see this as a key area in negotiations with India. In addition, India has received requests from Japan, Korea, Singapore, China and Brazil. The requests focus on modes 1, 2 and 3. Since the beginning of the Doha Round, most developed countries have made offers in this area and most new members have made commitments in this area as part of their accession negotiations. India has not made any requests in distribution services. It has offered commitments in commission agents' and wholesale trade services.

The focus of the negotiations is in **retailing**. The government is concerned that this could wipe out many small business and jobs and have a serious social impact. Furthermore, establishment of large retailers such as Wal-Mart requires considerable space, which is scarce in Indian urban areas. Allowing foreign entry in retailing could have a major impact on the urban land market.

Another area of service negotiations, which is controversial and which has been much debated in India is the question of trade in **educational services**. The value of trade in educational services was estimated at $30 billion in 1999. This estimate is, however, only for trade in higher educational services, and, even this, was about half the trade in financial services.

Educational services have been divided into five segments: (i) primary, (ii) secondary, (iii) higher, (iv) Adult, and (v) other. There is no agreement on the intended purpose of education as it has many consequences. It may be to fit people for employment, or to become better citizens or to inculcate in them the culture of the country etc. Usually there is a mix of motives and effects in the provision of education and the purpose and effects of education can vary at different levels of education. Most countries that have made requests and offers have done so in the field of higher education. No country seems to be willing to countenance liberalisation of primary education.

India is a major importer of educational services. Almost a 100,000 Indian students go abroad every year for higher education. In recent years a number of foreign organisations have set up facilities in India to provide educational services. The debate on liberalisation of higher education has got vitiated by the presence of many organisations in the field of education, which are not recognised in their own countries and who have not received clearance from the Indian authorities. Their presence is a failure on the part of the Indian states and has nothing to do with the WTO.

It is not clear whether agreeing to liberalisation at the WTO would make such illegal presence easier. It will in no way legalise it. Another fear that is often expressed is that liberalisation will lead to greater outflow of Indian teachers. This would aggravate the shortage of teachers in India. Also enrolments of foreign students in larger numbers in Indian universities would aggravate the competition for the limited number of seats.

While undoubtedly, liberalisation may create problems of short run adjustment, there is no convincing argument that it would harm Indian interests. Liberalisation may improve the higher education facilities in India, which are facing a severe resources crunch. Similar fears had been expressed about the ability of the Indian nationalised **banking sector** to survive when entry by private bankers including private foreign banks, was permitted. It was feared that Indian banks may not be able to face the competition. But the nationalised banks have faced the competition and increased their efficiency. Similarly, one should not be too pessimistic about the capacity of the Indian higher educational system to face competition. The government of India has offered to substantially liberalise educational services.

Another important aspect is that in many sectors Indian rules and regulations are much more liberal than the commitments we have made. This is similar to the case of trade in goods, where our applied tariffs are considerably lower than our bound tariffs. This wedge between the actual position and our commitments can be used in the negotiations.

In conclusion, one can say briefly that prospects for liberalisation of trades in services are not very clear. India seems to have a comparative advantage in the supply of many services and has expanded exports of such services. It is, however, difficult to analyse the impact of liberalisation in the case of trade in services. This makes negotiations difficult and so the negotiators proceed warily.

**Check Your Progress 3**

1) What are the trends in trade in services since 1990?

..........................................................................................................

..........................................................................................................

..........................................................................................................

..........................................................................................................

2) What are the controversial issues for trade in services in India?

.......................................................................................................

.......................................................................................................

.......................................................................................................

.......................................................................................................

## 13.7 LET US SUM UP

This Unit has explained to you the growing importance of services in the world trade. It exposes you to the consequences of inclusion of services in multilateral trade negotiations and discusses the outcome of the negotiations on services. The Unit has tried to explore the history of service negotiations since the Uruguay Round. It discusses the importance of India in negotiations under trade in services.

## 13.8 KEY WORDS

**De-industrialisation:** A decline over time in the share of the manufacturing in an economy, usually accompanied by growth in the share of services. Typically accompanied by an increase in manufactured imports, it may raise concern that the country is losing valuable economic activity to others.

**Distortion:** Any departure from the ideal of perfect competition that interferes with economic agents maximising social welfare when they maximise their own. It includes taxes and subsidies, tariffs and NTBs, externalities, incomplete information, and imperfect competition.

**General Agreement in Trade in Services (GATS):** It is the agreement, negotiated in the Uruguay Round that brings international trade in services into the WTO. It provides for countries to provide national treatment to Foreign Service providers and for them to select and negotiate the service sectors to be covered under GATS.

**Labour-saving:** It is a technological change or technological difference that is biased in favour of using less labour, compared to capital or energy or raw material.

**Most Favoured Nation**: The principle, fundamental to the GATT, of treating imports from a country on the same basis as that given to the most favoured other nation. In other words, it means with some exceptions, every country gets the lowest tariff that any country gets, and reductions in tariffs to one country are provided as also to others.

**National Treatment (NT):** The principle of providing foreign producers and sellers the same treatment provided to domestic firms.

**Plurilateral:** Involving some but not all WTO members

**Positive List:** It is a list of those items, entities, and products, etc. in an international agreement to which that agreement applies, with no commitment to apply the agreement to anything else.

## 13.9 SOME USEFUL REFERENCES

Agarwal, Manmohan. 2005. The Evolving World Economy: Issues in International Economic Governance, paper presented at seminar in JNU.

Altinger, Laura and Alice Enders. 1996. The Scope and Depth of GATS Commitments, *World Economy*, vol. 19, May, pp. 302-32.

Bhagwati, Jagdish. 1984. Splintering and Disembodiment of Services and Developing Countries, *World Economy*, vol. 7, no. 2, pp. 133-44.

Bhagwati, Jagdish and Marvin Kosters (ed.) 1994. *Trade and Wages, Levelling Wages Down*? American Enterprise Institute, Washington, DC.

Chennery, Hollis and Moises Syrquin. 1975. *Patterns of Development, 1950-1970*, Washington D.C., World Bank.

Dubey, Muchkund. 2006. WTO's Hong Kong Conference: An Appraisal, *Economic and Political Weekly*, vol. 21, no. 1, Jan. 7.

Sampson, Garry and Richard H. Snape. 1985. Identifying the Issues in Trade in Services, *World Economy*, vol. 8, no. 2, pp. 171-81.

Snape, Richard H. 1998. Agreements on Services in Anne O. Kruger (ed.), *The WTO As An International Organisation*, the University of Chicago Press, Chicago.

WTO. 2002. *Annual Trade Report*, Geneva.

World Bank. 2004. *World Development Indicators*, Washington, DC.

Whalley, John. 2003. Assessing the Benefits to Developing Countries of Liberalisation in Services Trade, *NBER, Working Paper No. 10181*, Cambridge. Massachusetts.

## 13.10 ANSWERS/HINTS TO CHECK YOUR PROGRESS EXERCISES

**Check Your Progress 1**

1) Read Section 13.2

2) Read Section 13.3

**Check Your Progress 2**

1) Read Section 13.4

2) Read Section 13.5

**Check Your Progress**

1) Read Section 13.6

2) Read Section 13.6

# UNIT 14 TRADE NEGOTIATIONS UNDER WTO: A HISTORICAL VIEW

**Structure**



## 14.0 OBJECTIVES

After reading this Unit, you will be able to

- appreciate the rationale for and basic principles of liberal trade under GATT;
- understand the agenda for UR round;
- learn agreements under UR round from developing country perspective; and
- discuss developing countries and international trading system.

## 14.1 INTRODUCTION

The inability to reach agreement on a draft declaration at the 2003 WTO Ministerial meeting at Cancun evoked mixed reactions. On the one hand, it was hailed as a victory for developing countries in the face of the obduracy of the developed countries. On the other hand the possible consequences of the breakdown rouse fears that it may be impossible to achieve the reduction of agricultural protection in the developed countries, which is in the interest of developing countries, as negotiations are the only way to reduce this protection. Furthermore, there are apprehensions that the failure will give a fillip to the adoption of bilateral pressure tactics by the developed countries - developing countries may not be in a position to resist such bilateral pressures. The negotiations have resumed with the 2005 Hong Kong Ministerial, although the road ahead is difficult. This Unit tries to place the developments in historical perspective to attempt to analyse the implications of the failure at Cancun and the options available to developing countries in general and India in particular.

## 14.2 GATT – ITS INITIAL YEARS

### 14.2.1 Rationale for Liberal Trade

Keynes' original plan for fashioning the international economic system called for three organisations—the International Monetary Fund (IMF) that would provide short term financing for balance of payments (BOP) needs, the World Bank (WB) that would provide long term capital for reconstruction from war damage and for economic development, and the International Trade Organisation (ITO) that would establish the rules to govern trade. The final conference negotiations for the establishment of the IMF and WB were held at Bretton Woods in New Hampshire, and hence their name as the Bretton Woods Twins or the Bretton Woods Organisations (BWO). The negotiations for the ITO were held in Geneva and substantial agreement was reached. But wide ranging amendments were introduced at the final conference at Havana where the developing countries played a more significant role than they had at Geneva while the war was still in progress.

The failure of ITO to be ratified still led countries to go ahead with part of the agenda. Tariff cuts were agreed on and implemented through a separate agreement, the General Agreement on Tariffs and Trade (GATT). This was only an agreement and did not set up a permanent and separate legal body. But over the years the functions of the GATT evolved and, though it did not have legal sanction as an institution, for all practical purposes, it acted as one. The main difference of the GATT with the IMF and the World Bank was that whereas staff members of the IMF and the Bank negotiate with member countries, this is not so at the GATT, even today with the WTO, even though the WTO is a legally sanctioned organisation. In the case of the GATT/WTO the member countries themselves negotiate the agreements. If a country violates the agreement it is not the WTO staff that responds; the adversely affected member country must complain.

The rationale for establishment of GATT was to provide a rule based trading system. Such a system would be more certain and so encourage investment and growth of export industries. When a country has a trade deficit, it can pay for the excess of imports over exports either from accumulated reserved or by borrowing. In the 1930s, during the Great Depression, countries had run out of foreign exchange reserves and could not borrow from the international capital market. So a country having an excess of imports over exports could not pay for the excess imports and had to reduce imports. A country often did this by reducing imports, through quantitative restrictions (QRs). Its imports were another country's, namely partner country, exports. So the partner country would find its exports decreasing and so it, in turn, would reduce its imports. This would hurt the first country's exports forcing it to further reduce imports. So a downward spiral was set up in which each country faced reduced exports, and lower employment and output in its export industries, and by the multiplier process in other industries. Policy makers tried to reverse this downward spiral and reverse it into an expansionary spiral by an expansion of exports by reducing import restrictions.

### 14.2.2 Basic Principles of the GATT

Recall from Unit 5.2 that the basic principles of the GATT are most favoured nation (MFN) and national treatment (NT). MFN means that if a country gives a concession to another country, it has to extend the concession to all countries with whom it has an MFN agreement. So MFN implies that all foreign suppliers are treated equally. NT means that once an imported good crosses the boundary and has paid the border charges it is accorded the same treatment as domestically treated goods. This regulates competition between the imported good and the domestic good. The two together provide certainty to foreign exporters about the competition they will face in the domestic market.

The negotiations for reduction of duties are conducted under the principle of reciprocity. A country in the negotiations is expected to give concessions on imports equivalent to concessions it receives on its exports. Also to provide certainty that tariffs would not be increased in the future, tariff rates were bound. Tariff rates could be below the binding but not above it. So, the negotiations are about the rate at which tariffs would be bound, not the actual rates.

A series of multilateral trade negotiations (MTNs) were undertaken under the aegis of GATT to reduce trade restrictions. GATT negotiations were restricted to manufactures. At US insistence, agriculture was kept out of the negotiations. Trade in textiles was also governed by the multi-fibre agreement (MFA). Under this agreement each developed country established quotas for the import of different textile items from each developing country.

### 14.2.3 Developing Countries and the GATT

With 11 out of the original 23 signatories, the developing countries were members of the GATT from the very beginning. They, however, played a very little role as two of the sectors of greatest interest to developing countries, namely agriculture and textiles, were excluded from the negotiations. Furthermore, these countries had adopted a policy of import substituting industrialisation and so were not interested in reducing tariffs. Moreover, apart from the high tariffs developing countries maintained they were allowed to maintain high protection levels QRs through two clauses. First, was the balance of payments clause. A country with a balance of payments deficit, and this had to be certified by the IMF, could institute quantitative restrictions (QRs), which were otherwise banned. At this stage the IMF was quite liberal in certifying that a country had a balance of payments problem and most developing countries did have BOP deficits. Second, developing countries were allowed to use QRs for development purposes.

In more recent times, the belief is that BOP deficits have to be tackled through exchange rate policy and not QRs. So the IMF is much less willing to certify that a country has a BOP problem and the members of the WTO are also unwilling to countenance QRs. Also opinion has moved against the use of trade restrictions for development. So there is much less accommodation for the adoption of restrictive trade policies by developing countries. For instance, India was forced to dismantle its remaining QRs when the US took the dispute to the Dispute Settlement Board and won its case. India was forced to remove these QRs in about 18 months.

Under these circumstances, the negotiations were mainly about liberalisation of trade in manufactures among developed countries. In seven rounds of multilateral trade negotiations (MTNs) before the Uruguay Round (UR) of the 1980s, which was the eighth round, average tariff on manufactures were reduced from about 40% to 6%. Furthermore, the use of QRs by developed countries on trade in manufactures was almost eliminated. But the import duties levied by the developed countries on imports from developing countries were considerably higher. For instance, currently the US collects as much revenue on imports from Bangladesh as on imports from France, though imports from Bangladesh are a fraction of those from France.

To reiterate, the developing countries did not engage in reciprocal liberalisation as sectors of interest to them were excluded from the negotiations and because of their import substitution policies. But since they constantly faced BOP problems, so they sought preferential access to markets of the developed countries. They also wished to grant each other preferential access without necessarily moving to free trade as required under GATT rules. These two exceptions to the MFN rule were legitimised under the enabling clause negotiated during the Tokyo Round. The developed countries did grant preferential access to exports from developing countries under the Generalised System of Preferences (GSP). But there were many restrictions on the working of the GSP so benefits to developing countries were limited. Preferential trading schemes among developing countries have been usually unsuccessful.

**Check Your Progress 1**

1) What was the rationale behind the establishment of GATT?

..........................................................................................................

..........................................................................................................

..........................................................................................................

..........................................................................................................

2) What are the basic principles of GATT?

..........................................................................................................

..........................................................................................................

..........................................................................................................

..........................................................................................................

3) What was the role played by developing countries under GATT?

..........................................................................................................

..........................................................................................................

..........................................................................................................

..........................................................................................................

## 14.3 THE URUGUAY ROUND

### 14.3.1 Agenda for the UR

The Uruguay Round negotiations that started in the mid-80s were path breaking and very complex and took 8 years to complete. The agenda for the

UR was agreed on after very contentious negotiations. But the agenda marked a very clear break with past negotiations. Agriculture was included and so were textiles. So these two sectors of great interest to developing countries were to be brought back into the system. The scope of the rule-based system was to be further expanded into entirely new areas. Services were included for the first time. The economic structure, particularly of the US had been changing, it was becoming more of a service economy, and the newer sectors wanted access into other markets.

Trade related intellectual property rights (TRIPRs) and trade related investment measures (TRIMs) were also included. In addition, a number of issues bedevilling the working of a liberal trade system were included. The eighties saw a large increase in contingent protection measures. Countries, were increasing investigations into allegations that exporting countries were subsidising exports or dumping them. Analysts felt that investigations were often a non-tariff barrier (NTB) and the rules regarding investigations and remedies needed to be tightened. Analysts also felt that the safeguard clause, which enabled governments to protect domestic industries from sudden damaging surges of imports in order to give them time to adjust was being misused. Protection could be by QRs and for extended periods. The dispute settlement procedure was not working well as there were no clear rules and time limits. Establishment of dispute settlement panels and adoption of the final report required consensus. Normally, the country against which the claim was made or which lost the case had also to agree, and this increased the difficulty of reaching agreement on establishing panels or of accepting the report, which would have resolved the dispute. As a consequence, not many disputes were bought before the system.

Developing countries faced a particular problem in the UR. The inclusion of services also forced developing countries to participate in the MTNs. As you learned in the previous Unit, liberalisation of service trade would often require modification of domestic legislation and developing countries had to participate to protect their interests. While the developing countries could stay on the sidelines when tariff negotiations were being held, they realised that they could not afford to do so when rules were being negotiated as that would mean that the rules would not reflect their concerns.

## 14.3.2 The UR Agreements

The UR agreements resulted in further cuts in tariffs on manufactures by the developed countries so that their average tariffs came down below 4 percent. Developing countries also made commitments. But this was in the nature of bindings rather than actual cuts. Till the UR, developing countries had bound few tariffs so they were free to increase them. Most developing countries bound their tariffs at a higher level than the actual tariffs they levied. India was an exception to this. Most tariffs on manufactures were bound at about 35% and this required reduction in tariff as the actual rates were higher than the bound rates. A start was made to deal with agricultural protection as all quantitative restrictions were tariffied (converted into equivalent tariffs), and tariffs had to be reduced. Furthermore, export and production subsidies granted to agricultural exports also had to be reduced. Agreement was also reached to phase out the Multi Fibre Agreement (MFA), though its implementation was considerably delayed. The regime for protection of intellectual property rights was strengthened, with the US getting almost all of what it wanted, and the ability of countries to put export requirements or local input purchase requirements on foreign direct investment, measures often introduced by developing countries, was eliminated.

Rules regarding the use of contingent protection, namely, levying of countervailing and anti-dumping duties were clarified. The rules regarding the use of protection under the safeguard clause were not only clarified but also tightened. The period for which protection could be granted to an industry damaged by a surge in imports was limited. But the major change was in the dispute settlement process. The different steps in the process, first mutual negotiations, then the appointment of a panel and finally if a party was dissatisfied with the decision to appeal to an Appellate Board, were clearly laid out and time limits for each stage prescribed. Furthermore, an important procedural change was made. The rule of positive consensus, which required all parties to agree on acceptance, was changed to the rule of negative consensus, under which a report was accepted unless all parties agreed on rejection. For instance, previously for a panel ruling to be accepted all members had to agree including the losing party, which was unlikely. Now, for a panel report not to be accepted all parties had to reject it, and usually the winning party will not reject it.

Another innovation was the institution of the trade policy review. Periodically each country's trade policy would be reviewed and discussed. The discussion resulted in greater transparency regarding a country's trade policies, and enabled members to express unhappiness regarding aspects of a member's policy, putting either moral pressure on the country or warning it what to expect in future negotiations.

### 14.3.3 The UR Agreements from Developing Country Perspective

Developing Countries were left very unhappy with the trade liberalisation results of the UR agreements as they felt that though they had made sacrifices in accepting services, TRIPs and TRIMs, their gains from liberalisation of agriculture and textiles had been limited. They did derive benefits from other aspects of the agreement. But, on the whole, benefits have been limited and they were therefore reluctant to accept further multilateral trade negotiations, particularly on an agenda determined by the developed countries. Ultimately they accepted a new Round at Doha but as the recent meeting at Cancun and Hong Kong illustrates there are serious differences regarding the agenda and the modalities of negotiations.

The UR agreement was a single unified undertaking. All members had to accept the final UR agreements as one package deal, whereas in earlier Rounds countries were allowed to opt out of certain agreements. For instance, developing countries in general did not accede to the government procurement agreement or the subsidies agreement negotiated in the Tokyo Round.

The developing countries had to accept all the discipline incorporated in the UR agreements. The least developed countries were given same leeway in implementation but there were considerable weakening of the Special and Differential Treatment accorded to them in earlier agreements. It is undoubtedly true that developing countries negotiated badly because they lacked the capacity to negotiate. But the cards have been stacked against them. Developing countries wanted limited negotiations as they did not have the capacity to research the implications of different negotiating options. They have also lacked the manpower to participate in all the different negotiations. The UR negotiations were split into about 14 groups, and developing countries had insufficient people to participate in all the groups.

The operation of the agreement has upset the fine balance of costs and benefits to developing countries to their detriment. For instance, developed countries were to cut their tariffs on agricultural goods by an average of 36% and on each tariff item by at least 15%. So, if on one good the tariff was 100 per cent and on another 5%, it would achieve an average 36% out by cutting the high tariff to 85% and the lower tariff to 2%. Obviously, the cut from 5% to 2% is not very significant, and the country continues to protect at very high rates the commodity it was really interested in protecting. Similarly, in textiles developed countries were to cut QRs by 51% in three stages by December 2004, and the last 49% on the last day of 2004. But again the wording of the agreement was such that in reality without violating the letter of the agreement, they cut QRs by only about 15-20%. So, while the developed countries did not violate the letter of the agreement, the developing countries did not receive the benefits they expected.

So developing countries did not receive the benefits they expected from the UR agreements. They also wished for postponement of the new Round till that they had the time to digest the results of the previous Round. It is a bit disingenuous to force them to engage in extensive negotiations for which they are not ready and then blame them when they do badly in such negotiations. After all, the EU and the US are able to stall negotiations when it is in their interest to do so. The mandated negotiations on agriculture were stalled by the EU – many claim that the large negotiating agenda for the current MTN arises from the need for the EU to balance the expected concessions in agriculture with gains elsewhere. Similarly, though many NGOs and some developing countries claimed victory for the result at Seattle, it is clear that negotiations then did not suit the US and they bear a major share of the responsibility for the collapse of the Seattle talks.

The agreements on the rules were more satisfactory from the viewpoint of developing countries. The new dispute settlement procedures have encouraged developing countries to bring their disputes before the WTO whereas they were earlier reluctant to do so, and they win many disputes. The new safeguards regime has also worked satisfactorily. It was feared that the sudden abandonment of the MFA regime would create problems for the textile industry in the developed countries and lead these countries to institute new measures to protect their textile industry. But despite a surge of textile exports from China, the new liberalised regime has broadly survived though growth of exports from China has been restricted. Similarly, fears about increasing contingent protection have not been borne out. Developing countries were major users of these measures immediately after the UR agreement. But anti-dumping and anti-subsidy investigations and impositions of countervailing and anti-dumping duties has declined in recent years.

## 14.4 THE DEVELOPING COUNTRIES AND THE INTERNATIONAL TRADING SYSTEM

The experience of the UR had made developing countries more wary of engaging in another Round of MTNs. Their fears were enhanced by attempts of the developed countries to include environmental and labour standards in the agreements as well as investment, government procurement, competition policy and trade facilitation into the agenda. Developing countries either feared that standards such as labour and environment standards may be used to protect industries in the developed countries, or the issues were not very germane to their trading concerns. What are the main trading concerns of developing countries?

As you learned in Unit 12, a major problem developing countries face is the *declining prices of primary commodities* as well as fluctuations in their prices. A second problem is the *barriers to trade* that they face in commodities of interest to them, a third is *standards* that are being imposed, and fourth is the *cost of compliance* with the various provisions of the WTO agreements.

The international policy making community has tried to avoid the issue of commodity prices. For long it was denied that there was a tendency for the terms of trade of primary commodities to worsen; when it has now become obvious that such a tendency exists, and has been responsible for the substantial decline in export earnings and growth in Sub Saharan African (SSA) countries, the problem is ignored. For instance, one has only to compare the importance given to the problems caused by capital flows to Mexico or Brazil or Russia or the East Asian economies; merely a handful of economies, compared to the neglect of the primary commodities; question that affects almost a hundred countries, and is of the utmost importance for the 49 least developed countries for whom manufactures are only a third of their export earnings. The cumulative loss from decline in their terms of trade during the period since 1975 has been 117 percent of GDP and almost cancels the 180 percent that they received in aid. The structure of the GATT/WTO may make it difficult to tackle the problem of commodity prices. Also it is not clear that commodity agreements can solve the problem. However, the problem of commodity prices is aggravated by the policies adopted by the developed countries. At the same time developed countries continue to protect their agriculture by very high rates of duties and by providing very high subsidies to their producers. These policies insulate their own domestic markets and so force the international markets to bear all the burden of adjustment aggravating instability there. Also, as is well documented, subsidised exports by the developed countries hurt farmers in developing countries. So reform of agricultural trade is very important for developing countries.

It was argued by some that developing countries had not benefited much from the liberal trading order established at the end of the Second World War as they had not engaged in the give and take of negotiations. Once they participated in these negotiations they could expect larger gains. But the experience since the beginning of the negotiations for establishing the agenda for the UR does not support this agreement.

The agenda for the UR included all the items that the US was pushing for: agriculture (many developing countries also had an interest in this sector), services, TRIPs and TRIMs, despite the opposition of the developing countries. The only item of singular importance to the developing countries included was the elimination of the MFA. The UR agreements were believed to benefit developing countries by the reduction in protection given to agriculture and textiles in the developed countries while they were likely to lose from the agreements on TRIPS and on services. As discussed above, it is very clear now that developing countries have not benefited very much from the agreements in agriculture and textiles. Finally, with the elimination of the MFA benefits from the agreement on textiles may flow.

The limited capacity of the developing countries that limits their ability to engage in extensive negotiations makes it extremely expensive to make all the changes in laws required by the agreements and to meet the sanitary and phyto-sanitary standards. Firstly, they have little say in the establishment of these so-called international standards. Secondly, there is often little basis for these standards so that these act as nothing but barriers to imports. For instance, Mauritania could not export cheese made from camel's milk to the EU because EU regulations just refused to recognise that cheeses could be made from camel's milk. In another case cut flowers exported by Kenya to Germany were re-exported to the US. The US initiated an anti-dumping case against Kenya rather than Germany. It just wasn't worth it for Kenya to fight the case.

Till the UR developing countries may not have got many positive benefits from the GATT agreements. But they were able to convince the contracting parties of their special needs, and were allowed to adopt policies they thought were conducive to their development, and get some limited benefit from schemes such as the GSP. The UR experience was a chastening experience. The agenda and the end results were largely fashioned by the developed countries. Their experience with the implementation of the UR agreements was unsatisfactory. Uptill now in the Doha Round, they have been successful in preventing inclusion into the agenda of items inimical to their interests. It is an open question whether they will be able to achieve positive benefits. Since most developing countries have liberalised, a more open trading system is in their interest, and they need to pursue liberalisation more vigorously.

A solution that is often proposed in India is that India should walk out of the WTO. We do not believe that would be a wise decision. As long as India participates in world trade this trade would be governed by some rules. Even though the rules of the WTO may be skewed against developing countries, they are better than the rules a particular country would be able to negotiate with powerful countries on its own. For instance, as long as China was not a member of the WTO it had to go through annual pressure from the US before its MFN status was renewed. The rule of law does protect the weak against arbitrary action by a powerful country. The solution, which is not easy, is developing countries must have a better analysis of their interest and adopt better negotiating strategies that take account of their long term interests and not look merely at short term gains. Developing countries have to learn to think strategically.

Developing countries in general and India in particular are much better prepared for this Round. There is considerably more research to refine their negotiating position. There is also considerable information sharing among developing countries. India has moved away from its earlier protectionist stance and has much to gain from trade liberalisation. India had opposed the inclusion of services in the UR, but has gained considerably from the exports of commercial services. Also fears of foreign competition can be exaggerated. It was believed that Indian nationalised banks could not face the competition from private banks both Indian and foreign. But with help from the Government, which re-capitalised them, Indian nationalised banks have raised their efficiency and are competing successfully with private banks. Their efficiency levels have been raised to almost the level of the private foreign banks.

**Check Your Progress 2**

1) What was the agenda of Uruguay Round (UR)?

.............................................................................................................

.............................................................................................................

.............................................................................................................

.............................................................................................................

2) What are the main agreements under UR?

.............................................................................................................

.............................................................................................................

.............................................................................................................

.............................................................................................................

3) What was the developing countries perspective under UR agreement?

.............................................................................................................

.............................................................................................................

.............................................................................................................

.............................................................................................................

## 14.5 LET US SUM UP

Developing countries have abandoned their earlier protectionist policies. An open trading system is important for them to get the maximum benefits from their changed policies. Developed countries may have little more to gain from liberalisation, and sustained developing country pressure may be necessary to achieve the liberalisation that is in these countries' interest. Fears of foreign competition can be exaggerated. Therefore the present Unit exposes you to the GATT since its initial years. It discusses the rationale for liberal trade, basic principles of the GATT and the role of developing countries in the GATT. The Unit goes on to explain the agenda for the Uruguay Round. The main agreements under UR and developing countrie's perspective is also explained.

## 14.6 KEY WORDS

**Multi Fibre Agreement (MFA):** It is an agreement among developed country importers and developing country exporters of textiles and apparel to regulate and restrict the quantities traded. It was negotiated in 1973 under GATT auspices as a temporary exception to the rules that would otherwise apply, and was superceded in 1995 by the ATC (Agreement on Textiles and Clothing).

**General Agreement on Tariffs and Trade (GATT):** A multilateral treaty entered into in 1948 by the intended members of the International Trade Organisation, the purpose of which was to implement many of the rules and negotiated tariff reductions that would be overseen by the ITO. With the failure of the ITO to be approved, the GATT became the principal institution regulating trade policy until it was subsumed within the WTO in 1995.

**Uruguay Round:** The round of multilateral trade negotiations under the GATT that commenced in 1986 and was completed in 1994 with the creation of the WTO. In addition it broke new ground by negotiating over agriculture, textiles and apparel, services and intellectual property.

## 14.7 SOME USEFUL REFERENCES


Finger M and Schuler, 2000. Implementation of UR Commitments : The Development Challenge, *The World Economy*, vol 23 (4). p. 511-25.

Grilli E.R. and Wang, M.C. 1988. Primary Goods Prices, Manufactured Goods Prices, and the Terms of Trade of Developing Countries, *World Bank Economic Review* vol 2 p. 1-47.

Winters L.A and Martin Will, 1997. *Developing Countries and the Uruguay Round*, Cambridge University Press.

Young, A, 1991. Learning by Doing : The Dynamic Effects of International Trade, *Quarterly Journal of Economics*, May.


## 14.8 ANSWERS/HINTS TO CHECK YOUR PROGRESS EXERCISES

**Check Your Progress 1**

1) Read Sub-section 14.2.1

2) Read Sub-section 14.2.2

3) Read Sub-section 14.2.3

**Check Your Progress 2**

1) Read Sub-section 14.3.1

2) Read Sub-section 14.3.2

3) Read Sub-section 14.3.3