

Trade Policies, Developing Countries, and Globalization

by

Will Martin

Development Research Group

World Bank

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Abstract

There have been very substantial reductions in the trade policy and other barriers inhibiting developing country participation in world trade. Associated with this has been a dramatic shift in the pattern of developing country trade, with a shift away from dependence on commodity exports to much greater reliance on manufactures and services, and greatly increased importance of exports to other developing countries. While the national level remains the principal focus of trade policy, developing countries have become increasingly involved in regional and multilateral trade negotiations. The multilateral system has made substantial adjustments to the increased importance of developing country members, but reforms in governance and a sharper distinction between positive and negative approaches to integration seem likely to be needed.

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Introduction

The past fifty years have seen dramatic increases in the importance of trade in the world economy. Trade has grown much more rapidly than output, and most of the countries that have grown the fastest have done so with rapid increases in their participation in world trade. Policies of import substitution were widely used in the 1950s, 1960s and 1970s, but appeared to be much less successful than the more export-oriented policies used in the high-growth economies of East Asia. By the 1980s, policy makers in developing countries, in particular, had begun to turn towards policies that involved more open trade regimes. By the end of the 1980s, virtually all of the centrally planned regimes that previously eschewed the use of market-based trade had either collapsed or made dramatic reforms that brought foreign trade and investment into a prominent place in their development programs.

Associated with these reforms of trade policy in developing countries was a dramatic change in the nature of their involvement in international trade. Prior to the mid 1980s, developing countries relied primarily on exports of commodities, a situation which exposed them to the higher volatility of commodity prices and to secular declines in commodity prices, and gave rise to concerns about dependency on imported manufactures. From the early 1980s, however, developing countries dramatically increased the share of manufactures in their exports. By the late 1990s, around 80 percent of their exports were manufactured goods, greatly diminishing the earlier developing country concerns about the role of trade.

The year 1994 was perhaps the high-water market of recent international policy enthusiasm for open trade policies. At Marrakech, an unprecedented 124 economies signed the Uruguay Round Agreement that introduced trade disciplines to agriculture and services and locked all members into a set of agreements, on issues such as the protection of intellectual property, that required the development of entirely new institutions in many developing countries. In the same year, in Bogor, Indonesia, the leaders of Asia-Pacific countries, representing nearly half of the world economy, set a goal of achieving completely free trade in the Pacific by 2010 for the industrial countries and 2020 for the developing countries. Many observers took a triumphalist view that free trade and ever-closer integration between countries, and the more general phenomenon of globalization, had become unstoppable.

The recent upsurge of concern about globalization, manifested in the streets of Seattle, Washington, Prague and other cities where international policy makers have met, makes it clear that a continuation of the globalizing trend of the last fifty years is far from inevitable. Participation in the trend to globalization is, as Wolf (2001) has noted, a choice that must be made by policy makers. Further, there is a strong interdependence between the decisions of policy makers. If some major countries turn away from world markets—as was the case in the 1930s – the result can be a downward spiral in world trade that hurts even those who would like to remain integrated with the world economy.

Even at the national level, the choice of policies to manage interactions with the world economy is not simple. More and more, trade policy reform requires the development of institutions, rather than merely the reform and streamlining of border barriers. Many of the “behind the border” reforms that are involved require institutional capacity that is in scarce supply in developing countries. In addition, supporting policies to help alleviate adverse impacts on particular groups are likely to be needed. As Rodrik (1997) argues, it seems likely that

globalization will be sustainable only if it is accompanied by policies that equip people to take advantage of the benefits of globalization.

There is also a serious concern that some recent approaches to trade policy reform may have created problems for developing countries. The World Trade Organization is much more comprehensive than its predecessor, the General Agreement on Trade and Tariffs (GATT), and this comprehensiveness appears to be creating some difficulties (Finger and Schuler 2001). Indeed, developing countries' problems in implementing the Uruguay Round agreements were one of the factors that derailed the Seattle Ministerial meeting of the World Trade Organization. But does this mean that trade policy reform has become a "hazardous obsession" for developing countries, as suggested by Rodrik (2001)? Or should developing countries, and their trading partners, instead become more selective and differentiated in the approaches that they take to reform of trade policies? Perhaps this involves differentiating sharply between those areas where implementation requires few resources, or actually saves resources, and those where it requires development and strengthening of institutions, and hence important and costly investments.

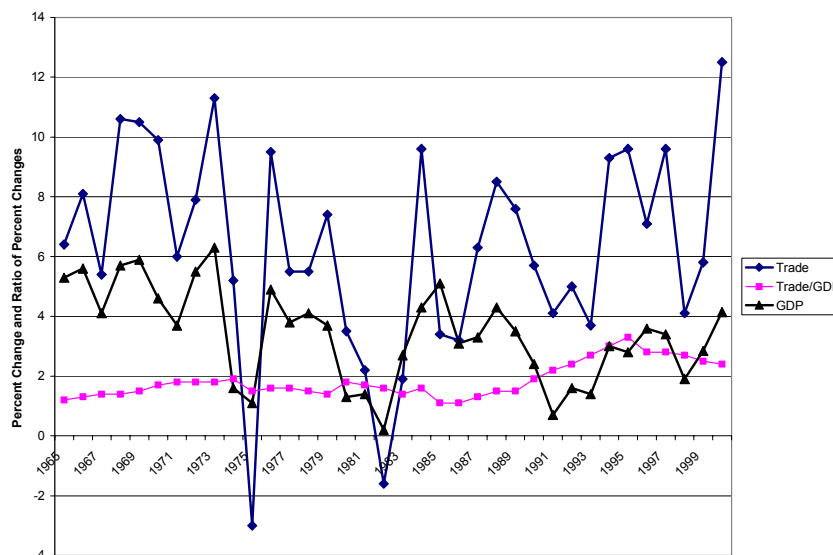
The question of what needs to be done about trade policies cannot be adequately answered without examining the current situation and the scope for improvement. Therefore, the next section of this chapter examines recent changes in trade policies and other barriers to trade. Then, in the third section, some major changes in trade patterns are examined. In the final section, some approaches by which further improvements in trade policy might be made are examined.

Recent Developments in Trade Policies and Other Barriers to Integration

The period since the mid 1950s has been a period of extraordinary growth in world trade, and in the openness of economies. Over the period since 1965, for which consistent data are available, world trade has grown more rapidly than world income in all but a few years of cyclical downturns (see Figure 1). In the 1990s, trade grew much more rapidly than income, with trade growing more than twice as fast as income over the period as a whole.

This very rapid growth in the openness of world economies reflects a number of factors, including: reductions in trade barriers; reductions in transport costs; and reductions in the costs of communications. Related influences include the increase in the importance of trade in manufactures, for which two-way trade is much more prevalent than for commodities, and the fragmentation of production processes, which necessarily involves much more international trade in components (Ng and Yeats 1999; Deardorff 2000). In the remainder of this section, we first examine some of the key changes that have taken place in barriers to trade, and then examine some key changes in patterns of trade.

Figure 1. Trade Growth, GDP Growth and the Smoothed Trade/GDP Growth Ratio
 Source: World Bank, *Global Economic Prospects 2001*



Developments in Trade Barriers

In the industrial countries, reductions in protection from the high levels reached in the 1930s were already under way at the time of the establishment of the GATT in 1947 and continued under successive rounds of GATT negotiations. The process of reform was not simply one of reducing tariffs. During the 1950s, an important component of liberalization was the abolition of quantitative restrictions introduced for balance of payments reasons. Nor was the process of liberalization smooth and continuous. During the 1950s, agriculture effectively escaped from the multilateral system as a consequence of exceptions made for domestic support price schemes. During the 1960s and 1970s, exports of textiles and clothing from developing countries were put under a system of quotas that discriminated by country, and violated all of the fundamental principles of the GATT. As tariffs fell, forms of protection such as voluntary export restraints and antidumping measures came to play a more important role.

However, for the manufactures trade that was at the heart of the GATT process of liberalization, the reductions in protection were dramatic. From rates of 50 percent or more in the late 1940s, the average tariffs levied by industrial countries on their imports of manufactures had fallen to 4.1 percent in 1988, early in the Uruguay Round (Abreu 1996). And for most of these goods, the coverage of nontariff barriers fell as well. Trade in manufactures between the industrial countries grew rapidly, with much of it involving two way trade in products within the same type of good.

In the developing countries, trade liberalization was much slower to get under way. Import substitution policies found ready converts amongst policy makers, particularly in newly independent countries. The belief that infant industries could be nurtured behind protective barriers was appealing, particularly given the perception that industrialization was necessary for development. The dependency theory concerns enunciated by Raoul Prebisch gave these concerns a powerful fillip, by associating open markets with dependence on commodities, and identifying a secular decline in commodity prices with long-run declines in the terms-of-trade for

such economies. In addition, import substitution policies found strong support from the vested interests that gained either from the protection provided by, or from access to rents created by, nontariff barriers.

Developing countries used a range of policy measures to implement their trade policies. One popular option, particularly in commodity exporting countries, was to grant a monopoly to a particular firm¹. Tariff barriers were ubiquitous, as were nontariff barriers, such as quotas and licenses. Foreign exchange restrictions frequently imposed large additional taxes on trade.

The widespread use of nontariff barriers in developing countries created particularly serious problems both for managing trade policies, and for the quality of governance in general. Once nontariff measures such as quotas or licenses are used to restrict trade, they become scarce and therefore valuable. Their value changes over time in response to: the volume of trade permitted; shifts in the demand for and supply of the goods domestically, and changes in their international prices. The extent to which measures such as quotas protect² domestic producers and consumers is not observable unless there is a market in these quotas. And the recipients of such quotas typically lobby hard to prevent such markets from existing for fear that knowledge of the extent of their gains from receiving the quotas will lead to pressure for their abolition.

Studies by Krueger (1980) found that, under import substitution regimes, import quotas frequently generated quota rents that amounted to a very large percentage of GDP. Frequently, such quotas and licenses were allocated in a way that provided strong incentives to use real resources in pursuit of the rents associated with them, resulting in wasteful dissipation of scarce resources (Bhagwati 1983). These policies also provided an incentive for firms to be located in or near the capital city, where access to the politicians who controlled the allocation of quotas was likely to be better (Livas Elizondo and Krugman 1992). Finally, of course, the presence of such policies creates powerful incentives for corruption, with its sharply adverse consequences for institutional quality, for development and for equity (World Bank 2000).

The protective effects of tariffs, quotas and licenses in developing countries were frequently reinforced by distortions in foreign exchange markets. In their simplest and most transparent form, foreign exchange restrictions on current account involve an overvalued official exchange rate, coupled with some form of secondary market exchange rate in which a domestic price for foreign exchange is determined, and scarce foreign exchange is allocated among uses. Where the secondary markets are legal, as in China after the early 1980s (Martin 1993a) or Nigeria in recent years, the extent of the trade distortion created by this policy can be observed and is frequently very substantial.

In the presence of the profoundly distorted trade and foreign exchange regimes that characterized most developing countries prior to the 1980s, it was frequently difficult to know what incremental policy reforms would be welfare improving. Some limited policy guidelines were available. For instance, policy changes that increased transparency, and unified the distortions across firms, would generally be welfare improving. For instance, replacement of foreign exchange allocation by a secondary market approach would generally be welfare improving (see Dervis, de Melo and Robinson 1981 for an example). However, simply opening up to foreign investment, without reducing barriers, could easily be welfare-reducing (Brecher

¹ This approach was historically popular in today's industrial countries as well. Irwin (1992) notes that, in England, the term free trade did not originally refer to a situation with zero tariffs, but to the absence of a state-endowed trading monopoly.

² Or tax, as in the case of an export control.

and Diaz-Alejandro 1977) and policies that imposed export performance requirements on foreign investors could be second-best welfare improving (Rodrik 1987).

The political attractions of import-substituting policies to developing country policy makers were not effectively countered by the multilateral trading system prior to the Uruguay Round (1986-1994). In this era, developing country policy-makers generally subscribed to the theory of import substitution, and focussed their efforts in the GATT on obtaining unreciprocated improvements in their access to industrial country markets under the rubric of “special and differential treatment”. This policy was of some help to those countries that received preferential market access, by improving their terms of trade. However, it had a number of adverse economic consequences. Firstly, the policy made it difficult to bargain for improvements in their market access in the products of greatest interest to them. Secondly, such access was frequently constrained by quantitative restrictions and the risk of preference erosion or removal. And thirdly, this policy approach meant that domestic exporters had no incentive to lobby for reductions in domestic protection as a way of improving their access to partner markets.

It was no coincidence that, during the period in which developing countries focussed on import substitution and on obtaining increased market access in the industrial countries without reciprocation, the industrial countries introduced new barriers in areas of particular interest to developing countries, such as agriculture and textiles and clothing.

In the long run, however, it is ideas and experience, rather than political power, that are the most influential determinants of the broad thrust of policy. As Keynes (1936) famously observed “Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back... Sooner or later, it is ideas, not vested interests, which are dangerous for good or evil”. A small group of developing economies, primarily in East Asia, had either not followed the orthodoxy of import substitution, or had used complementary export promotion policies as part of an export-oriented development path. By the end of the 1960s, the outstanding performance of economies such as Hong Kong, the Republic of Korea, and Taiwan (China) had begun to attract attention. This evidence, combined with critical assessments of the performance of import substitution regimes in practice (see Krueger 1980) contributed to a gradual evolution in thinking towards more outward-oriented policies.

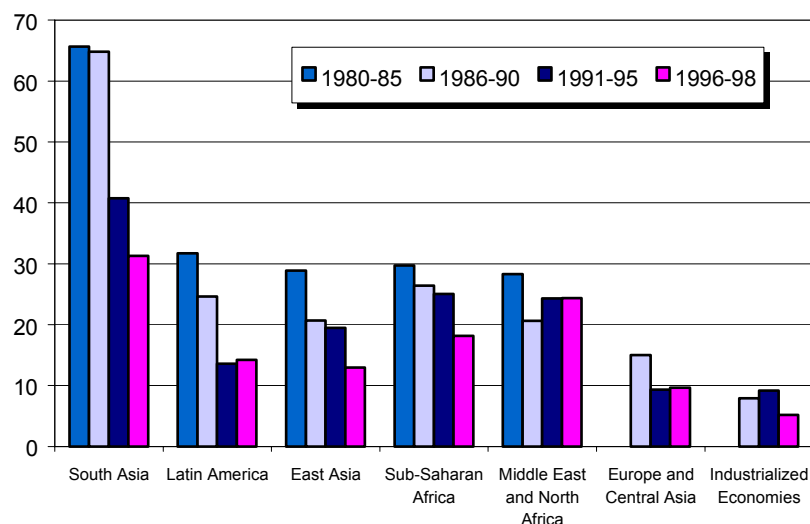
In light of this experience, developing countries began to adjust their policies towards more open trade regimes. This change in attitude manifested itself in the Uruguay Round, when developing countries first began to play the “main game” of exchanging market access “concessions”. Developing countries were willing to “bind” their tariffs³ on 100 percent of their agricultural imports, and on over 60 percent of their imports of industrial products (Abreu 1996). In addition, they agreed to a “grand bargain” in which intellectual property protection of primary interest to the industrial countries was introduced in return for the abolition of quotas on textiles and clothing, and the introduction of disciplines on agricultural protection.

But the most profound and far reaching manifestation of developing countries’ interest in greater participation in trade is evident from the wave of unilateral trade reforms that has swept the developing countries. These reforms have affected all regions, and all of the major types of policy distortions. As discussed in *Global Economic Prospects 2001* (World Bank 2001, chapter 2) and presented in Figure 3, average tariff rates in developing countries have halved, from around 30 percent in the early 1980s, to around 15 percent in the late 1990s. The absolute reductions in tariff rates in developing countries have been much higher than in industrial

³ That is to enter into a commitment not to increase their tariffs above a specified level recorded in a schedule of concessions at the WTO.

countries and, of course, decreases from a higher level are likely to have a much greater welfare benefit than corresponding decreases from a lower base (see Martin 1997). In addition, the dispersion of tariff rates, which typically increases the welfare cost of any given average tariff rate (Anderson 1995), was substantially reduced.

Figure 3. Changes in tariff rates since the early 1980s



Source: World Bank (2001)

One must be careful when examining changes in tariff rates, because a decline in tariffs may reflect substitution of nontariff barriers for tariffs. However, during this period, the coverage of nontariff barriers, including state trading monopolies, in developing countries also appears to have fallen considerably, as is evident in Table 1.

Another important dimension of reform has been a sharp reduction in the number of countries using foreign exchange restrictions on current account, and in the average foreign exchange premia. The World Bank (2001) reports that the number of developing countries applying foreign exchange restrictions on current account has fallen sharply. Table 2 shows foreign exchange premia for a range of countries in the 1980s and 1990s. This table highlights two things. Firstly, that average foreign exchange market distortions were enormous in the 1980s, and that these premia in most developing countries, in most regions, have fallen to very low levels.

While the simple average foreign exchange rate premium is highest in the Middle East and North Africa, at 46.5 percent, this high rate is almost entirely due to large premia in Algeria and Iran. If these two outliers are excluded, the average rate falls to only 1.4 percent. When Nigeria is excluded, the average premium in Sub-Saharan Africa is less than 10 percent, down from 112 percent in the mid 1980s. The impact of foreign exchange rate premia in the few countries with exceptionally high premia can only be determined with additional information on retention rates and other features of the foreign exchange rate regime. Clearly, however, for most countries, the premia are now small enough to imply that foreign exchange distortions impose relatively small taxes on trade.

Table 1. Frequency of total core nontariff measures in developing countries, 1989–98

Country	1989–94	1995–98
	%	%
East Asia and the Pacific (7)	30.1	16.3
Latin America and the Caribbean (13)	18.3	8.0
Middle East and North Africa (4)	43.8	16.6
South Asia (4)	57.0	58.3
Sub-Saharan Africa (12)	26.0	10.4

Note: Figures in parentheses are the number of countries in each region for which data are available.

Source: World Bank (2001), based on Michalopoulos 1999

Table 2 Average black market premium (*percent*)

	1980-89	1990-93	1994-97
Total ^a	82.0	78.2	20.3
East Asia	3.6	3.6	3.2
Middle East And North Africa	165.6	351.6	46.5
-Excluding outliers ^b	7.1	8.8	1.4
Latin America	48.7	13.1	4.4
South Asia	40.8	45.1	10.1
Africa	116.5	28.6	32.2
-Excluding Nigeria	112.1	25.8	9.6

Notes: ^a Sample of 41 developing countries

^b Algeria and Iran

Source: World Bank (2001)

Changes in Trade Patterns

The changes in trade policies and the reductions in trade barriers that have occurred in recent years have been associated with major changes in developing countries' role in the world economy. In particular, over the period in which developing countries have been reducing their trade barriers, the composition of developing country exports has changed in fundamental ways. Since the 1980s, developing countries have drastically increased their reliance on manufactures exports, and increased their reliance on exports to other developing countries. Further, exports of services have become much more important for developing countries.

The highly protectionist policies followed by most developing countries prior to the 1980s were frequently designed, at least in part, to stimulate industrialization. However, one of their effects was to greatly constrain countries' ability to participate in the more dynamic parts of international trade—trade in manufactures, and trade in services. Both of these typically require access to intermediate inputs, capital and technology that are best obtained from abroad.

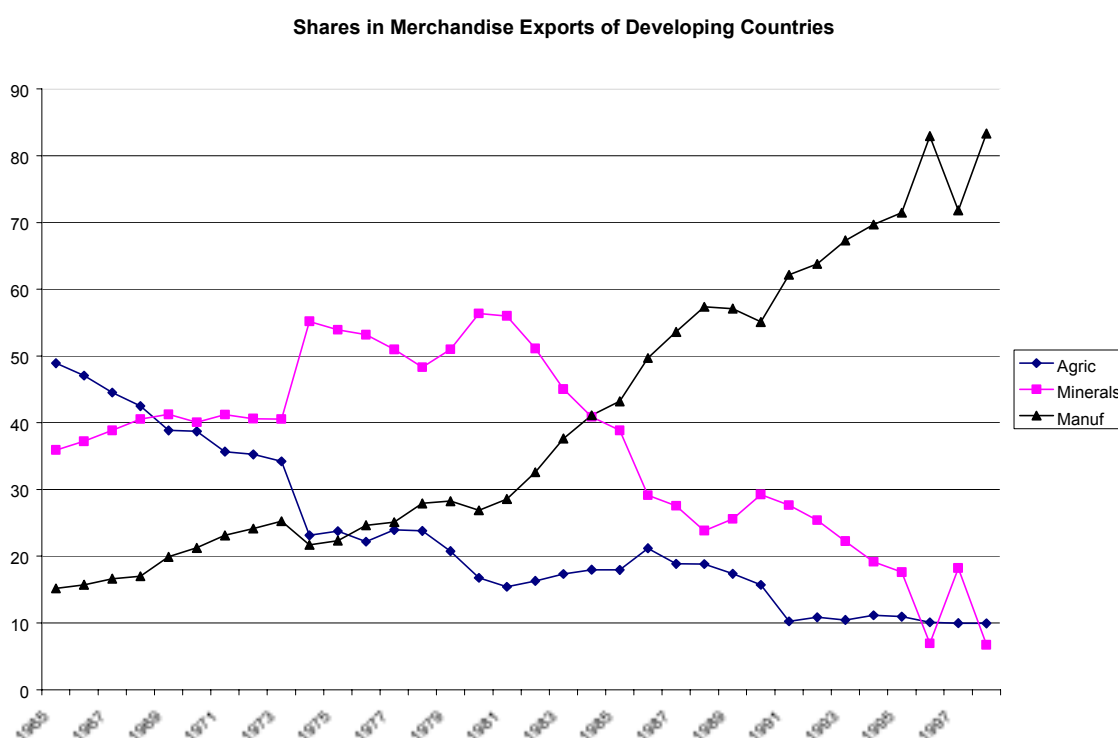
In the remainder of this section, we first consider developments in the exports of developing countries as a whole, and then changes in the export patterns of selected groups of relatively commodity-dependent economies.

Exports of Developing Countries as a Group

Figure 4 shows the changes that have occurred in the pattern of merchandise exports from developing countries as a group over the period from 1965 to 1998. This figure reveals the dramatic nature of the transformation in the commodity specialization of developing country⁴ exports. In 1965, agricultural commodities made up roughly 50 percent of developing country exports, and manufactures only around 15 percent.

⁴ A definition of developing countries broadly consistent with those likely to elect for developing country treatment in the WTO was followed in preparing this chart. The group therefore includes Singapore, Hong Kong (China), the Republic of Korea, and Taiwan (China) which were clearly developing economies in 1965, and of which all but Korea are currently classified as high income by the World Bank.

Figure 4. The Changing Pattern of Merchandise Exports from Developing Countries



Source: GTAP Version 5 Database. See Endnote 1.

The share of manufactures in developing country exports has risen without interruption, except for a transient decline in 1997 associated with the onset of the East Asian crisis. The share of agricultural products has shown a similarly consistent decline, falling to around 10 percent by 1998. The share of metals and minerals has fluctuated, with a rise in 1973 associated with the OPEC increase in oil prices lifting the share of this category from 1973 through the early 1980s. However, since the early 1980s, the share of mineral exports has declined almost continually, falling below 10 percent of total developing country exports by 1998. Clearly, developing countries as a group have been leading the change in the overall pattern of world trade, transforming their export pattern from commodities to manufactures much more rapidly than the world as a whole.

These dramatic changes in the composition of developing country exports clearly have many underlying sources. One that is surely important has been the relatively high rate of accumulation of human and physical capital in developing countries (Nehru and Dhareshwar 1993; Nehru, Swanson and Dubey 1995). While increases in capital appear to be much less important than technological change as a source of aggregate growth (Easterly and Levine 2000), trade theory suggests that rapid growth in these factors should increase the importance of those sectors that use them intensively. Gehlhar, Hertel and Martin (1994) found that rapid accumulation of these factors contributed to a strong shift into manufacturing activities for export, and out of agricultural activities in East Asian developing countries. The shift out of agriculture in developing countries does not appear to have been driven by higher productivity growth in manufacturing. In fact, productivity growth over recent decades appears to have been

higher in agriculture both in developed and developing countries (Martin and Mitra 2001; Bernard and Jones 1996).

Along with the changes in the commodity composition of exports have come substantial changes in the direction of exports. As is shown in Figure 5, only 17 percent of developing country exports were destined for other developing countries in the mid 1960s. By 1995, this share had increased to over 40 percent. This share fell in the 1996-1998 period but, even in 1998, was twice as high as in the mid 1960s. Interestingly, the increase in the share of developing country exports going to other developing countries is not only due to the increase in their reliance on manufactures exports. In the 1960s, the share of manufactures exports going to other developing countries was much higher than the share of agricultural and mineral exports—which were primarily sent to the industrial countries. However, the shares of agricultural and mineral products exported to other developing countries have risen substantially over time.

This increase in the importance of developing countries as markets for each others' goods reflects a number of factors, including growth in the share of developing countries in world trade, and the liberalization of developing country trade. Whalley (1980) predicted that unilateral, non-discriminatory liberalization of the type observed in developing countries in recent decades (World Bank 2001) would result in a substantial increase in south-south trade. This increase in the importance of developing country markets has important implications for the market access barriers facing developing countries. Forty percent of developing country exports now go to other developing countries, and most of the tariff burden they face on their exports is imposed by other developing countries (Hertel and Martin 2001).

Another important change in the pattern of world trade has been a substantial increase in the importance of services trade. Figure 6 presents data on the shares of commercial⁵ services in the exports of goods and services from major country groups. The services exports represented here are somewhat narrower than the concept of trade in services used in GATS. Karsenty (2000) estimates that this category of services now accounts for roughly 60 percent of the total exports of services covered by the four modes of the General Agreement on Trade in Services (GATS). In the early 1980s, commercial services made up 17 percent of the exports of high income countries—a share that has since risen to 20 percent. In the low and middle income group, services trade started out much less important, at 9 percent, but rose much more rapidly, to 17 percent. Amongst the relatively poor countries of Sub-Saharan Africa, the share also grew rapidly, from 10 to 15 percent.

⁵ Commercial services is a balance of payments concept covering services traded across borders (GATS Mode 1) or through movement of the consumer (GATS Mode 2). It excludes services traded by establishing a service-providing firm in the consuming country (GATS Mode 3) or by temporary movement of service providers (GATS Mode 4).

Figure 5. The share of exports to other developing countries has increased.
 Source: GTAP 5 Database.

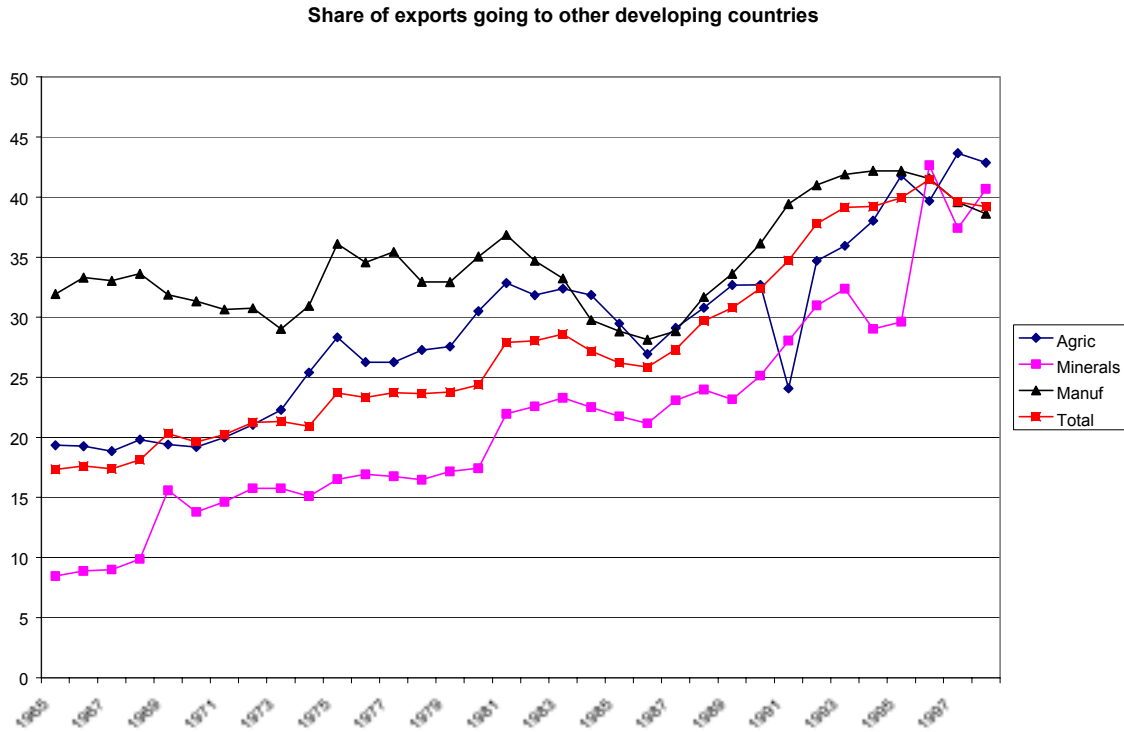
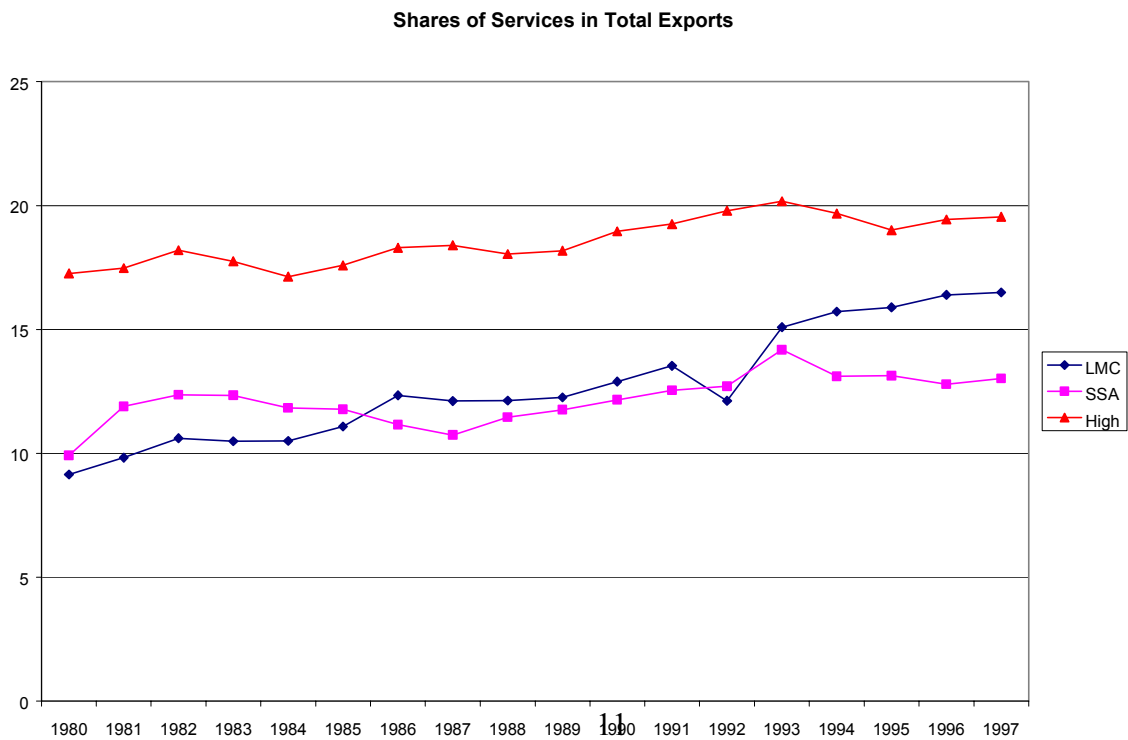


Figure 6. The importance of services in total exports of goods and services
 Source: World Bank (2001), World Development Report.

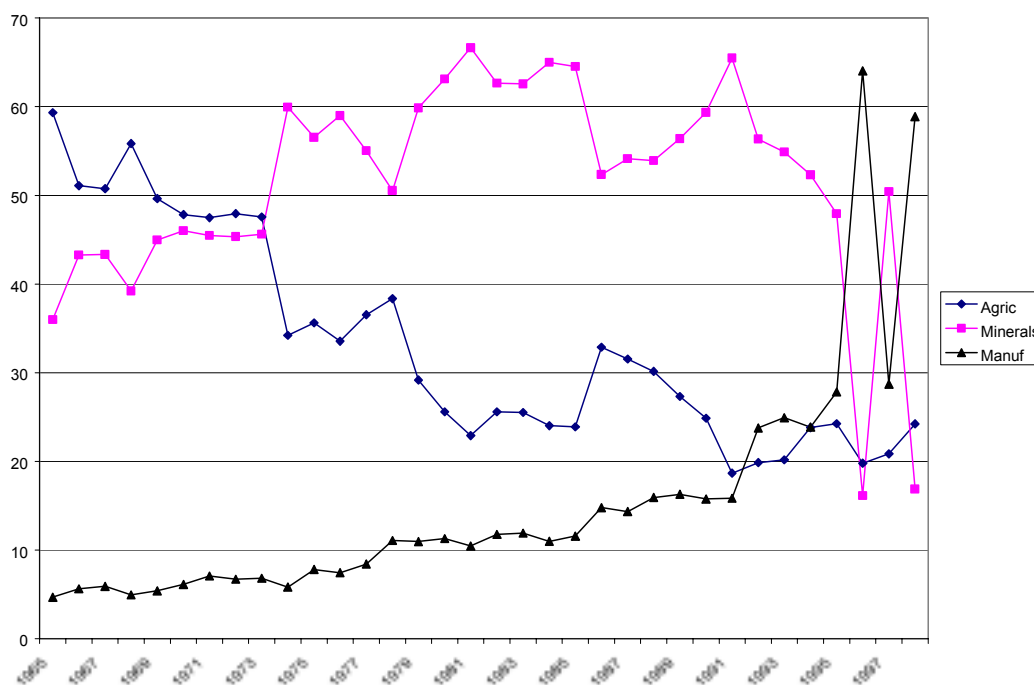


Exports of Sub-Groups of Developing Countries

The considerable success of developing countries in transforming their export patterns may be consistent with a sub-group of these countries being left behind, and continuing to be dependent on traditional commodity exports. To see whether major sub-groups of developing countries have been left out of the process, it is useful to examine the developments in individual countries and groups. As an indicator of this tendency, Appendix Table 1 presents information on the shares of manufactures in developing country exports for the 65 countries identified in the GTAP 5 database for the year 1997.

An interesting feature of this table is the very high share of manufactures in the exports of a wide range of developing countries. Many developing countries, including relatively low-income countries such as China, Bangladesh and Sri Lanka, have manufactures shares in their exports that are above the world average of 81 percent. Others, such as India, Turkey, Morocco and Indonesia have shares that are nearly as high as the world average. The countries and regions where the share of manufactures remains low include reform-oriented countries such as Chile and Uganda, and a large number of countries in Sub-Saharan Africa, the Andean region, and the Middle East and North Africa that have been less successful in integrating into the world economy. Clearly, a great deal depends on the composition of exports within these commodity groups. If countries have been developing new commodity exports and markets, as in the case of Chile, then a heavy dependence on commodity exports may be consistent with rapid growth in exports.

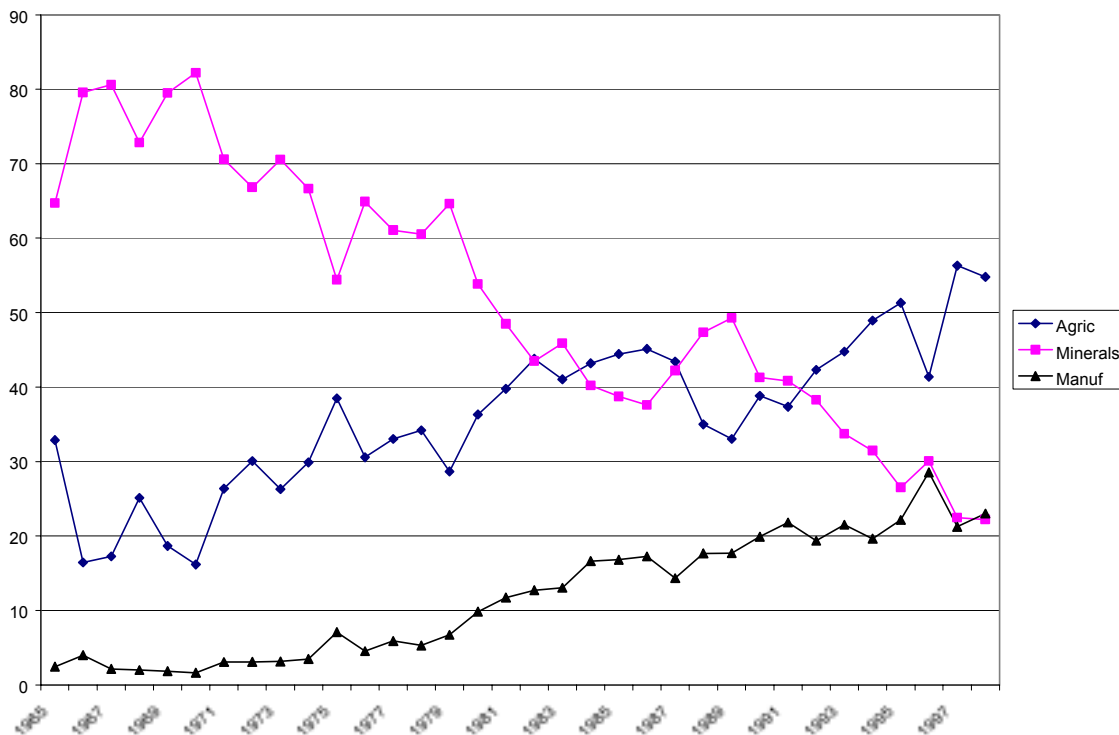
Figure 7. The Changing Composition of Exports from Sub-Saharan Africa



For regions such as sub-Saharan Africa, there is more of a concern that continuing dependence on commodity exports may reflect a lack of investment in the infrastructure, plant, equipment and skills needed for successful participation in global trade. Figure 7 presents changes in the composition of exports from Sub-Saharan Africa as a whole to see whether there have been substantial changes in the export pattern of this region. This figure shows that there has been a consistent upward trend in the share of manufactures exports from this region, from 10 percent to around 25 percent in the late 1990s. While still low relative to other regions, it is clear that there has been a substantial change even within this region.

Clearly, the results for a large bloc such as sub-Saharan Africa may be influenced by changes in a few relatively large economies. As a guard against this problem, Figure 8 presents data on the trade pattern for a group of five relatively low income countries in sub-Saharan Africa: Malawi, Mozambique, Tanzania, Zambia and Zimbabwe. Even for this group, the share of manufactures in total exports has increased substantially, from 2 percent in the mid-1960s to roughly a quarter in recent years.

Figure 8. Export shares from Five Sub-Saharan African Countries



This brief survey of patterns of trade has highlighted three striking changes in developing country export patterns. The first is a rapid increase in the importance of manufactures exports from developing countries. The second is a marked shift in the direction of developing country exports towards other developing countries. The third is a sharp increase in the importance of services exports from developing countries. Together, these changes mean that there has been a fundamental shift away from the traditional north-south model of the world economy in which developing countries exporting commodities in return for imports of manufactures. This

diversification of exports and shift away from commodities has many important advantages. In particular, it helps reduce the volatility of export returns, and diminishes the concerns about potential price declines as exports expand (Martin 1993b). As Mayer (2001) notes, this is particularly the case for developing countries that are able to promote shifts to more capital and technology intensive exports by promoting capital accumulation and increasing the skill levels of their workforces. The dramatic increases in exports of manufactures from developing countries have, however, contributed to protectionist concerns in both industrial and developing countries, and to the emergence of new concerns about issues such as labor standards. Clearly, this set of changes has important implications for trade policy, and for broader thinking about development. The frequently cited stylized fact (see, for example, Todaro 1994, p52) that developing countries depend on primary product exports surely requires re-examination.

Approaches to Policy Reform

Ideally, trade policies would be determined at a national level by a government seeking to maximize national welfare. This government would possess at least one policy instrument for each policy goal it sought to achieve, and so have a realistic chance of achieving its objectives. It would then, as specified by Rodrik (2001) seek to maximize national welfare, taking into account the balance between its objectives, and recognizing constraints such as weak institutional capacities.

Unilateral reforms

Clearly, this unilateral approach is and should be central to achieving reforms, and can be successfully pursued in many countries and in many situations. For many types of reform, it is both necessary and sufficient, and no international engagement is required. For other types of trade reform, it is necessary but not sufficient. If a country does not know what its goals are, or how to achieve them, it is unlikely to be able to use international negotiations effectively to secure its goals. An indication of the dramatic changes that can be made using a unilateral, national approach is provided by the sweeping reforms that developing countries have pursued during the past twenty years.

Some have suggested that trade policy may play a role in macroeconomic management, particularly in countries where policy-makers' hands are tied by exchange rate policy commitments. In particular, some have proposed using tariff increases to stimulate domestic demand. Such policy proposals are fraught with danger. While increases in protection may provide some short-term stimulus to import-competing sectors, the longer-run impact is likely to be much more strongly contractionary as the higher cost of capital goods reduces the incentive to invest. McKibbin and Tang's recent analysis (2000, p989) for China shows that the initial macroeconomic stimulus to output of an increase in protection is likely to be very small, and to be overwhelmed by the longer term contractionary effect as the higher cost of capital reduces the incentive to invest in the country. Even if such an approach were feasible for a single country, it would have an adverse impact on other trading partners through reductions in the demand for their exports. If a number of countries should attempt to follow such a beggar-thy-neighbor approach, the contractionary impact on output is likely to be even larger, as was shown dramatically during the Depression of the 1930s.

Some would argue that conditionality by the World Bank and the IMF has been important in bringing about these reforms. While in a sense flattering to these organizations, this view seems seriously misguided. These institutions have declined considerably in their importance as international lenders during the 1990s, and hence in their policy leverage. Key countries such as China and India that have undertaken far-reaching reforms have frequently listened with interest to these institutions, but have undertaken their reforms in their own time and at their own pace. Other countries that have undertaken market-opening reforms have typically undertaken them because their policy makers were convinced that they would be beneficial—and frequently brandished conditionality requirements as a means of countering domestic opposition. Finally, there is considerable evidence that conditionality imposed on unwilling governments has a poor record of success (World Bank 1998). While there have been some cases, such as Indonesia during the Asian financial crisis of 1997, where conditionality was used to bring about particular trade reforms, the international institutions rarely have such leverage—and, following a torrent of criticism during that crisis, seem unlikely to use it for purposes unrelated to crisis mitigation in the future. It seems clear that changes in the views of countries' policy makers, rather than conditionality, account for the breadth and depth of reform that has taken place during the past two decades.

While nationally-determined trade policy choices remain the most important influence on global trade policies, there are limitations to relying solely on this approach. Firstly, the process of formulating domestic policies tends to include only the interest groups directly affected by trade barriers. In this situation, the relatively more powerful interest groups are frequently able to obtain trade barriers that benefit their individual interests, while diminishing those of the society as a whole. Secondly, trade distortions in one country impose an externality on partner countries by causing their terms-of-trade to deteriorate. Thirdly, government commitments to policy reform are not binding on their successors, making it difficult to secure the investments in export-oriented activities that are needed to obtain the full gains from liberalization. Fourthly, a focus on policy making for individual countries leaves countries without rules to regulate their interactions with their trading partners. As in domestic interactions, there are substantial potential benefits, particularly for smaller and weaker trading entities, from agreed rules (World Bank 2002).

External Engagement

External engagement, with regional trading blocs or through the multilateral trading system, can help address each of these concerns. It can help address the interest group problem by widening the process of policy formulation to include powerful interest groups involved in export activities, as well as the import-competing interest groups normally engaged in the process of trade policy formulation⁶. Once the policy process becomes more inclusive, it is more likely to focus on policy reforms that reduce inefficiency and increase real welfare than on policies with narrow redistributive goals (Olson 1971).

International trade negotiations can directly deal with the terms-of-trade problem resulting from foreign trade barriers by increasing market access in partner markets, and by increasing the supply and lowering the price of imports from partners (Bagwell and Staiger 1999). Developing countries' commitments to lower barriers in the future, or to maintain low

⁶ However, some important interest groups, such as consumers and the poor, tend to have difficulty in pressing their concerns in the trade policy formulation process and external engagement does not overcome this problem.

barriers, can acquire greater credibility when made through international treaty commitments than through autonomous reforms. Finally, internationally agreed rules and dispute settlement mechanisms can help provide protect small countries against unilateral actions by larger countries.

International trade agreements can also help overcome the inability of autonomous governments to commit their successors to continuation of a policy reform. This is potentially an important gain in countries with a long history of policy reversal, where investors are likely to be unwilling to invest on the basis of a policy reform that may turn out to be short-lived. Such a gain, of course, assumes that the international treaty is sufficiently strong as to substantially reduce the likelihood of reversal. The World Bank (2000) concludes that this is more likely in north-south regional arrangements than in south-south trade blocs. Such commitments are clearly also relatively strong at WTO, where commitments are reinforced by a well-developed mechanism for trading partners to take action if commitments are not honored.

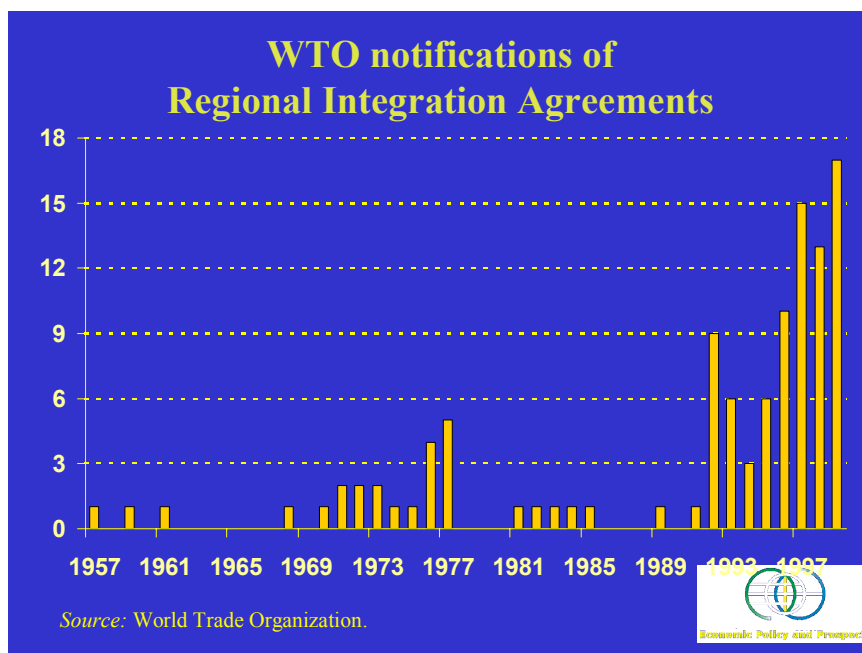
Finally, a well-developed international treaty requires a system of rules, which can be of particular value in themselves. The current multilateral system involves, for example, the most-favored-nation (MFN) principle, which prevents any country from unilaterally imposing a higher tariff on one partner than on others. Such rules are of particular value to small developing countries which might, otherwise, find themselves facing much higher trade barriers than other countries. Even for relatively large developing countries such as China and Vietnam, the protection provided by WTO membership has proved a powerful incentive for international engagement (Ianchovichina and Martin, 2001; Martin 2001, Martin and Ianchovichina 2001). Whalley (1996) notes that strengthening the multilateral system was an important goal of many of the developing countries that participated actively in the Uruguay Round.

While both the regional and multilateral approaches to trade reform share the four features outlined above, they are very different in many other respects. In the next two sections, we consider their potential use by developing countries.

Regional Approaches

The regional approach to international engagement frequently appears attractive for two reasons: because it provides preferential access to partner markets, and because it may be easier to make progress with as small number of partners than with the 142 members of the WTO. These perceptions, and the increasing length of multilateral negotiations, have contributed to the dramatic increase in the number of regional negotiations during recent years evident in Figure 10. However, these advantages are typically much less substantial than they might at first appear. These issues are discussed in detail in World Bank (2000) and only some of the key distinctions of importance to our discussion are considered below.

Figure 10. Notifications of regional arrangements to the WTO



The apparent advantage of preferential access needs to be discounted for two reasons. Firstly, because it is the obverse side of the coin of trade diversion. When a country enters a preferential trading arrangement, it must give preferential access to its trading partners. This reduces government revenues⁷ in the importing country, and creates incentives to divert its import sourcing from the most efficient and lowest-cost suppliers to the countries that happen to be its partners. Trade diversion generates net costs to the bloc, and changes in the prices received by exporters generate redistributions of income between bloc members—redistributions that may, or may not, be acceptable to the members. Trade diversion also creates a potentially serious dynamic cost, particularly for so-called south-south trade blocs. Diverting trade away from the most advanced suppliers of imports can potentially diminish countries' access to inputs that would allow it to accelerate its growth through improvements in its technology (Coe, Helpman and Hoffmaister 1997). From the point of view of efficiency, preferential trade liberalization is always second-best, and whether a particular bloc will have a positive or negative impact can only be determined by examining the specifics of the situation and the agreement.

A second reason to discount the value of preferential market access is that it is likely to diminish in value over time. One common cause of diminution in the value of such access is the grant of preferential access to additional trading partners. Irwin (1992) points out that the MFN principle arose in the 19th century because of uncertainties about the value of preferences when subsequent bilateral trading partners could be given better terms of access. A second source of erosion of preferential access is subsequent MFN liberalization by trading partners. Fukase and Martin (2001) find, for instance, that for all of the newly acceding members of ASEAN, further liberalization of their MFN tariffs is highly advantageous. A third source of erosion in the value of preferential access is the imposition of restrictive rules of origin that raise the costs of obtaining preferential access.

⁷ Such declines in government revenues must typically be made up from other sources where the marginal cost of funds is typically above unity, and frequently substantially so, making the loss of government revenues potentially more serious than it would first appear.

The other purported advantage of regional trade blocs—the ease of negotiation—should also not be overstated. Many such negotiations take an extremely long time to reach a successful conclusion, or fail outright either in negotiation or in operation. Even those negotiations that appear to succeed frequently exclude products such as agricultural commodities that are “sensitive” in the more powerful partners.

Regional arrangements can have some important positive features. They can allow some progress to be made on trade policy reform in situations where this is difficult in the multilateral system⁸. They can help countries develop expertise in international co-ordination of trade policies-- an advantage likely to be particularly useful for micro-states (Andriamananjara and Schiff 2001). Under some circumstances, regional arrangements can also help countries develop common positions. This latter feature is most clear in the case of a Customs Union, where a common external trade regime is maintained. However, the existence of a regional trading bloc is neither necessary nor sufficient for this advantage. Members of a free trade area do not need to have common positions on external trade policies, and negotiating groups such as the Cairns Group⁹ can formulate common policy positions in the WTO without having common trade policies.

There are also some important investment issues associated with regional trade arrangements. Whether a country attracts foreign investment after accession depends to a significant degree on how its endowments compare with those of partners. Countries such as Spain and Portugal benefited enormously¹⁰ from accession to the EU, in part because their factor endowments were closer to those of the rest of the world than were those of the other members of the European Union. By contrast, Tanzania and Uganda appear to have lost from participation in a regional agreement with Kenya during the 1960s. With high external trade barriers, there was substantial trade diversion within the region, and virtually all of this favored the manufacturing sector in Kenya, whose factor endowments were closer to the world average. In many cases, this means that developing countries will be better off forming a regional bloc with developed countries, rather than developing. Such north-south trading blocs also have advantages in terms of the credibility of commitments (World Bank 2000).

Multilateral approaches

The multilateral trading system had a particularly inauspicious beginning. The so-called Bretton Woods negotiations that gave rise to the International Monetary Fund and the World Bank included proposals for a wide-ranging International Trade Organization (ITO). However, this proposal failed when it was not ratified by the US Congress and only a vestige of the ITO survived as the General Agreement on Tariffs and Trade (GATT). This vestige was extremely simple, but encapsulated some key principles, such as the MFN principle, that had been found to work successfully in nineteenth century treaties involving many members (Hoekman 2000). It used a very conservative decision rule, the consensus principle, which meant that no proposal to which *any* member objected could be put into effect.

⁸ This appears to underly the current upsurge in enthusiasm for regional arrangements globally, and particularly in the Pacific, where over 20 new preferential trading blocs are currently under discussion (Scollay and Gilbert 2001).

⁹ The Cairns Group is a group of agricultural exporting countries from developed and developing countries that seeks to establish common positions on agricultural trade reform issues.

¹⁰ These benefits were not automatic, and required substantial domestic reform to be realized. Greece benefited much less from its accession to the EU, despite similar underlying advantages.

The original GATT had relatively few members, and most developing countries effectively excused themselves from the main focus of the institution—the reciprocal exchange of “concessions” on market access. This reduced the number of active participants on most issues to a relatively small group of industrial countries. Without strong participation by developing countries in the market access negotiations, two areas of particular interest to developing countries—agriculture, and textiles and clothing—were effectively excluded from the system. However, for the manufactures of interest to developed countries, the system was enormously successful, and brought about truly dramatic reductions in protection through seven rounds of negotiations.

The approach of the GATT focussed on negative integration (Tinbergen 1965) in which countries agreed to constraints on their policy freedom, such as eliminating discrimination between suppliers, the abolition of nontariff barriers, limits on tariffs (tariff bindings), and reductions in tariffs. For this type of integration, there was no need to develop or strengthen institutions at the country level. In fact, these reductions reduced the demands on their institutions. It is much easier, for example, to run a customs service that administers a low and uniform tariff than one that must administer and enforce quotas, and levies high and widely divergent tariff rates. Because the rules for negative integration have such low implementation costs, they could be relatively uniform across countries. In many cases where particular rules required the development or strengthening of institutions—such as customs valuation, standards and anti-dumping-- these rules applied only to the sub-set of members choosing to sign these agreements (Stern and Hoekman 1987).

The Uruguay Round ushered in a new era (Martin and Winters 1996). For the first time, developing countries engaged comprehensively in the core business of the WTO-- the exchange of market access concessions. Developing countries played a pivotal role in ensuring that agriculture was returned to GATT disciplines, and that the grotesquely distorted quota regime for textiles and clothing was phased out. The coverage of the agreements was also extended to services and to intellectual property. Many disciplines that had previously applied only to members of stand-alone agreements were brought within the “single undertaking” of the Uruguay Round. The World Trade Organization was established and given a much stronger system for dispute resolution.

The Uruguay Round was very successful in deepening the traditional negative integration of trade in manufactures. The coverage of tariff bindings was greatly increased in developing countries, and tariff bindings were cut substantially in both developed and developing countries (Abreu 1996). In addition, changes in the rules reduced the impact of some nontariff barriers, such as voluntary export restraints, that had escaped disciplines in earlier negotiations.

For developing countries, there were two particularly important developments that were perhaps not sufficiently remarked at the time. One was the increase in requirements for positive integration—that is rules requiring the development or substantial strengthening of institutions (Tinbergen 1965, p78). This was most noticeable in the case of trade-related intellectual property (TRIPS), but also arises in areas previously covered by voluntary codes, such as customs valuation, government procurement, product standards and antidumping. As Finger and Schuler (2001) have pointed out, the costs of implementing these agreements can be substantial.

Another change in the Uruguay Round was that the new agreement ruled out some of the policies that have frequently been used as part of a transition process from a distorted to a more open trade regime, and which can be welfare-improving in a second-best sense. These prohibitions included rules against investment measures under the agreement on trade-related

investment measures (TRIMs), and the outlawing of foreign exchange retention schemes as export subsidies. However, many other second-best policy measures continue to be allowed. For instance, duty exemption and duty drawback schemes for inputs used in the production of exports are explicitly allowed, as are subsidies for research and development. It is difficult to say definitively whether it is desirable to rule out policies that may be useful in a second-best sense. If the effect of a ban is to cause countries to move from an inefficient policy directly to a first-best policy, then it will increase welfare. If, however, the ban causes countries to use policies that are worse than the second-best approach, then it makes them worse off.

A foreign exchange retention scheme, for instance, is typically a partial offset against the taxation of exports resulting from exchange rate overvaluation, rather than an export subsidy (Martin 1993). If developing countries have the institutional ability to move directly to a relatively open system, then these transitional arrangements are unnecessary. However, as Dervis, de Melo and Robinson (1982) have pointed out, allowing foreign exchange retention and secondary market trading of foreign exchange can greatly reduce the cost of a distorted foreign exchange regime. For a WTO member with a highly distorted foreign exchange regime, such as Nigeria in Table 2, there is a risk that the best could become the enemy of the good! Similarly, Rodrik (1987) has shown that export performance requirements can be welfare-increasing in distorted economies. Given the rapid reductions in barriers in developing countries in recent years, this escape valve is clearly much less important than it formerly was, but may still have been useful as a transitional step in some cases. Of course, there is a risk that these policies, badly applied, could be very damaging and, in this case, their abolition is likely to be welfare improving.

Despite the dramatic increases in the size of the membership, and in the coverage of the multilateral system with formation of the WTO, relatively few changes were made in the operation of the system. The consensus principle is still used for major decisions, and all members are represented equally on the executive governing body, the General Council, as well as at Ministerial meetings. While this gives smaller developing countries much more representation than they would have with a smaller executive body, they have much less influence than the equality of representation would imply. Logistical difficulties mean that many developing countries are inadequately represented in Geneva, and hence unable to participate fully in the wide range of WTO activities. Further, size matters in many cases, particularly in areas such as dispute settlement where only larger countries can effectively threaten to retaliate against illegal measures.

In its early years, the WTO was able to bring to fruition sectoral negotiations in areas such as Financial Services and Telecommunications, and an agreement on trade liberalization on information technology. These were remarkable achievements in that they were brought about without the cross-sectoral tradeoffs usually required to make reform politically acceptable to sufficient members. However, it proved difficult to continue the momentum, and attempts to liberalize maritime services and to bring about broader liberalization in a subset of sectors failed. A great deal remains to be done in liberalizing trade.

Table 1 presents estimates of the static, annual gains to real incomes from complete elimination of tariffs in industrial and developing countries or, equivalently, the costs of retaining these barriers. These estimates are conservative in that they are based on the situation after the Uruguay Round liberalization commitments, and particularly the promised abolition of MFA quotas, have been completed. They are derived using a version of the Global Trade Analysis Project (GTAP) model that ignores scale effects and any dynamic benefits of trade

liberalization¹¹. They also ignore the benefits obtainable from the abolition of other protective barriers, such as antidumping duties, safeguards and similar measures, for which reliable, comprehensive, estimates of trade barriers are not currently available.

Table 1. Implications of post-Uruguay Round Liberalization on Welfare, 1995 billion						
Liberalizing Region:	<i>Benefiting region:</i>	Agriculture And Food	Other Primary	Textiles & Clothing	Other Manufactures	Total
Industrial						
	<i>Industrial</i>	110.5	-0.0	-5.7	-8.1	96.6
	<i>Developing</i>	11.6	0.1	9.0	22.3	43.1
	Total	122.1	0.0	3.3	14.2	139.7
Developing Countries						
	<i>Industrial</i>	11.2	0.2	10.5	27.7	49.6
	<i>Developing</i>	31.4	2.5	3.6	27.6	65.1
	Total	42.6	2.7	14.1	55.3	114.7
All Countries						
	<i>Industrial</i>	121.7	0.1	4.8	19.6	146.2
	<i>Developing</i>	43.0	2.7	12.6	49.9	108.1
	Total	164.7	2.8	17.4	69.5	254.3

The results presented in Table 1 suggest that the costs to developing countries of tariffs in the industrial countries are \$43 billion per year. Of these costs, around \$12 billion arise from industrial country agricultural protection. The cost of industrial country tariffs on manufactures is \$31 billion per year, of which almost a third results from tariffs on the sensitive textile and clothing sectors. The results presented in the table suggest that the benefits to developing countries from abolishing their own protection are fifty percent larger than those obtainable from abolishing industrial country liberalization. The gains from removing developing country agricultural protection account for almost half of these gains. These estimates are extremely conservative, in that they exclude the gains obtainable from elimination of other forms of protection such as antidumping duties and from product standards used for protectionist purposes, rather than as means to achieve valid goals such for valid product quality goals. Further, they exclude the benefits from reducing protection on trade in services—protection that many studies estimate to be at least as large as the benefits from protection on merchandise trade.

Despite the potential gains from further trade liberalization, and despite repeated attempts, it proved impossible to finalize an agreement on maritime services, and proposals to identify a set of sectors for total liberalization were unsuccessful. The disasters of 1999, during which the institution was at first deadlocked over the choice of Director-General and was then unable to agree on an agenda for a new round of negotiations, revealed deep problems. Some of these resulted from long-standing controversies, such as those in agriculture. Another set of problems resulted from implementation concerns related to the Uruguay Round. Added to these were serious concerns by developing countries about their ability to participate effectively in decision-making within the organization. Complicating things further were pressures from

¹¹ See Anderson, Francois, Hertel, Hoekman and Martin (2000) for a description of the model and experiments.

industrial countries to expand the agenda into issues such as trade and labor standards, that were bitterly opposed by developing countries.

In *agriculture*, the major controversies and dividing lines were not greatly different from those encountered during the Uruguay Round. The countries with high agricultural protection, mostly industrial countries in Europe and East Asia, found themselves aligned against a north-south coalition of agricultural exporting countries. There were major controversies about whether the goal was complete liberalization of measures such as agricultural subsidies. Another major source of discord was whether non-trade concerns, frequently labeled *multifunctionality* by the protecting countries, should be allowed to affect protection levels. In addition, there were new agriculture-related controversies about biotechnology and whether imports could be restricted under the so-called precautionary principle in the absence of scientific evidence.

The *implementation concerns* of developing countries covered a number of issues, of which some of the more important were: the slow pace of removal of quotas on textiles and clothing; lack of market opening in agriculture; antidumping measures in the industrial countries; and TRIMs measures in developing countries. In addition, there were concerns about the implementation of the TRIPS agreement, the Customs Valuation Agreement, and in complying with many product standards requirements. For many developing countries, the Uruguay Round was a grand bargain, in which developing countries took on new commitments in, for example, TRIPS in return for liberalization of textiles and clothing, and agriculture.

Unfortunately, the rules on textiles and clothing were written in a way that allowed the industrial countries to greatly delay the abolition of their quotas. Instead of specifying the progressive abolition of quotas, the rules specified the progressive integration of textiles and clothing under GATT disciplines. The industrial countries were allowed to choose the products to be integrated, and chose, almost without exception, to begin by integrating the products in which developing countries do not have a comparative advantage. Developing countries that had expected half of their exports of textiles and clothing to be freed from quotas by 2002 found that almost all of them would remain restricted until December 31, 2005.

The rules on agriculture similarly contained flexibility that both developed and developing countries used to reduce the extent of their liberalization. The impressive reduction commitments for import barriers of 36 percent for developed countries and 24 percent in developing countries were undermined by “dirty tariffication” and “ceiling bindings” that allowed countries to greatly inflate the level of their initial barriers¹². Fortunately, future liberalization will not involve the messy process of converting nontariff barriers into tariffs and so this problem should not recur.

The antidumping rules of the WTO make no economic sense, and allow countries to restrict imports when there is no economic justification¹³. Developing countries bear a disproportionate burden of these measures, both in industrial country markets, and in other developing countries. While Japan is seriously burdened by antidumping actions Finger, Ng and Sonam (2000) show that some developing countries face 30 times as many antidumping actions

¹² The intention was to calculate the tariffs that would create the same restrictive effect on trade as the previously-operating nontariff barriers by calculating the increase in domestic prices resulting from these barriers. Unfortunately, it is difficult to do this precisely, and many countries seized upon the resulting opportunity to set higher tariff bindings.

¹³ Most of the practices against which antidumping measures are routinely obtained are normal commercial practices—such as selling at lower prices when demand conditions are weak (Finger 1993). Only in cases of predatory dumping is there a case for intervention, and then under competition policy principles, rather than the flawed rules of antidumping, under which only the interests of competing firms are taken into account.

per dollar of exports as does Japan. It is clear that some form of contingent protection is needed when countries find themselves politically unable to maintain an open stance, but safeguard systems that do not involve the abuses of antidumping can be developed (Finger 1998).

Many developing countries have reported difficulties in phasing out some of their TRIMs measures in line with their WTO commitments. Whether the specific measures are economically justified second-best responses to a trade regime that creates incentives for inward-oriented investment with low or negative returns to the host country can only be determined after a careful economic evaluation of the specific measures. Clearly, far fewer of these measures are economically justified in countries with average tariffs of around ten percent, and with few or no nontariff barriers, than when barriers were much more formidable. However, such investment measures tend to involve powerful economic interests, and are therefore likely to be politically difficult to remove.

A number of Uruguay Round agreements, such as those on TRIPS, customs valuation and product standards, require developing countries to establish institutions that they did not previously have, or to greatly strengthen their existing institutions. Further, some of these agreements effectively codify the established practices of the industrial countries, rather than seeking approaches to deal with these problems in the developing-country context. Finger and Schuler (2000) conclude that the Customs Valuation Agreement does not address the problems faced by developing countries, and may cause serious losses of customs revenues under the conditions prevailing in many developing countries.

The TRIPS agreement has raised many concerns about its implications for the cost of essential medications. While there is widespread appreciation in developing countries of the need for some form of intellectual property protection in the emerging knowledge economy, there are concerns that the current rules might make price many patent drugs and other vital patented goods out of the reach of poor people in developing countries. This issue has been highlighted by a recent court case against the South African government for, *inter alia*, allowing parallel imports of drugs in an attempt to lower prices.¹⁴

The **participation problem** for the smaller developing countries remains serious. Even for those countries that have a permanent representative in Geneva, the diversity and complexity of the issues makes it impossible to participate effectively on more than a small range of issues. Almost half of the least developed countries are not even represented in Geneva, making it impossible for them to participate fully.

The proposals for **new issues** generated a number of concerns among developing countries. Proposals on trade and labor standards raised fears of protectionist measures that would strike against the comparative advantage of developing countries. Proposals for trade and competition policy raised concerns about the need to develop new institutions, and divergent approaches taken by different countries. Trade and investment proposals foundered largely on concerns about restrictions on the ability of countries to attract, or reject, particular types of investment.

¹⁴ Interestingly, the TRIPS agreement does not preclude parallel imports of products produced legally in another country. If patented goods were priced optimally from the viewpoint of the patent holder, it is likely that a segmented pricing strategy would be followed, with substantially lower prices being offered in developing countries.

The Way Forward

The foregoing highlights the dire straits in which the multilateral trading system finds itself. One response is a greatly highlighted interest in regionalism. There has been an upsurge in such interest, particularly in the Pacific, where more than 20 regional arrangements are currently under consideration (Scollay and Gilbert 2001). Unfortunately, this is unlikely to be a lasting solution. As argued above, this form of external engagement offers few of the advantages of the multilateral system, and many disadvantages. But at least it does attempt to increase integration with the world economy. Some opponents of globalization, forgetting the lessons of history, are advocating that countries turn inwards.

What then would we propose? Our first suggestion is to keep a strong focus on how trade policy can be used to promote development. It is also important to remember that most of the policy actions needed to create a development-friendly trade policy will be within the authority of the government acting unilaterally. WTO rules almost never constrain a government from abolishing nontariff barriers¹⁵ and rarely constrain a government from moving to a lower and more uniform tariff¹⁶. Most of the institutional development needs related to trade can also be undertaken by governments acting unilaterally and actions undertaken in this way can be tailored to the specific circumstances of the country and its needs, as suggested by Rodrik (2000).

Throughout, governments must remember that the mercantilist “game” of market access concessions is merely a veil over the primary objective of the exercise, combating the domestic vested interests that ceaselessly seek protection for private gain. If this mercantilist “game” of seeking foreign market access and resisting domestic market liberalization is played too assiduously, the entire exercise loses much of its value.

Similarly, governments can take advantage of the considerable flexibility allowed under the TRIPS agreement to develop a regime that best meets their development needs. One way of viewing this is through a competition policy lens, where competition policies are used to attenuate the monopoly power bestowed on intellectual property owners by their patents (Maskus and Lahouel 2000). At the same time, governments can take action to expand the coverage of intellectual property rights to cover forms of intellectual property they produce, but which are currently under-produced because they lack adequate intellectual property protection (Finger 2001).

Revitalizing the multilateral trading system is a much more difficult and complex task, and one that must be urgently addressed. In thinking about this, it is very useful to distinguish between negative and positive approaches to integration, particularly when considering implications for developing countries. Once the broad goals in these areas are set, the key question is how the governance structures of the WTO might be modified to deal with the problems that have become so evident.

Negative approaches to integration, where WTO rules restrict the protection that governments can impose, have always been central to the multilateral trading system. Important examples include the Most Favored Nation rule that requires countries to the same tariff on

¹⁵ The one notable, and disgraceful, exception is the quotas imposed on developing countries under the Agreement on Textiles and Clothing.

¹⁶ A possible exception is when some tariffs have been bound very low at the WTO and cannot be raised in an attempt to make the tariff regime less variable.

imports from all WTO members¹⁷; and the tariff bindings that prevent a member from increasing its tariffs above the agreed level. This form of rule almost always reduces administrative costs, and reduces administrative burden on agencies such as Customs, making a “one size fits all” approach appropriate for all members. This does not imply that all countries should have the same tariff rates, since the importance of tariff revenues, and the balance between import competing and export oriented interest groups will differ from country to country.

Although protection to manufactures in developed countries has, on average, fallen to very low levels, there are still substantial gains to developing countries from liberalizing agriculture, manufactures and services (Anderson *et al* 2001). There is clearly a strong case for aggressively pursuing further market integration under the traditional negative integration approach. The experience in the one area where this has been tried, manufactured products traded between industrial countries, suggests that quite extraordinary reductions in the level of protection¹⁸ can be achieved when this approach is followed. If the WTO could make a fraction of this progress in reducing barriers in agriculture and services, it would have created enormous opportunities for developing countries. It will also be important to continue reducing protection on manufactures, especially those in developing countries, which account for over 70 percent of the tariff burden imposed on developing country exports of manufactures (Hertel and Martin 2001).

In the area of positive integration, there is a need for considerable care. Given the differences in institutional capacities between countries, there is much less of a case for a “one size fits all” approach in these areas. One important requirement for new rules should be that they be goal-oriented, rather than prescribing the approach to be followed. As Finger and Schuler (2001) have noted, prescribing procedures that work in the institutional setting of a developed country is likely to be unhelpful in the very different setting of a small, least-developed economy.

Some positive integration rules currently on the books are likely to need reform, and care needs to be taken in designing such rules in new areas. There is a good case for carefully examining rules in areas where problems have been identified, such as customs valuation, product standards and intellectual property (Finger and Schuler 2001). The same issues need to be addressed in the design of rules in new areas such as trade facilitation. Designing rules that achieve the objectives while allowing the needed flexibility in implementation is likely to be difficult. However, some experience is available from the different experiments undertaken in preferential trading blocs. Another approach might be to revert to a plurilateral approach, allowing members to choose whether to participate, and allowing experimentation before such policies are adopted in all countries.

To make progress in these areas will likely require changes in the governance of the WTO and in its dispute settlement mechanism. These reforms will be all the more urgent with the accession of China and other important trading nations, such as Russia, Saudi Arabia and Vietnam, that are currently in the accession queue. China, in particular, will likely play a very important role given its size, the diversity of its trading interests, and its experience in the development of institutional reform (Martin and Ianchovichina 2001). However, the accession of

¹⁷ Exceptions are allowed for preferential trading arrangements, but these increase the administrative burden and costs.

¹⁸ GATT had much less impact on the pattern of protection than on its level. Pincus (1977) notes that the sectors with relatively higher protection in the United States after seven rounds of GATT negotiations were similar to those that had been highly protected before the Civil War. But the average level was dramatically lower.

these major developing countries will create additional pressure for reform because it will increase the number of countries expecting a “place at the table” on many issues.

The key to reform of the WTO’s governance must, ultimately, lie primarily in the member countries. As Hoekman, Sapir and Winters (2001) have emphasized, the ultimate responsibility for “ownership” of WTO trade policy outcome must lie at home. Unless governments conduct consultations with civil society on the issues arising at the WTO, there is likely to be little “ownership” of policies, and there is a serious risk of backlash. Governments also need to consider very carefully their allocations of resources to WTO activities. Blackhurst, Lyakurwa and Oyejide (2001) point out that many of the countries with little or no representation in Geneva have quite strong delegations to the UN in New York, or to the European Commission in Brussels, and may be able to strengthen their participation in the WTO by reallocating resources between their different missions.

Developing countries also need considerable assistance from the international community in the implementation of many of the positive integration measures that are mandated by current agreements. Finger and Schuler (2001) point out that developing countries in many cases made binding commitments of trade reform or protection of intellectual property in return for “best endeavors” offers of technical assistance from industrial country members of the WTO. Clearly, more technical assistance is required in areas like TRIPS and customs administration. However, where this is funded from the development budget, expenditures for implementation of these agreement need to be compared with other expenditures, such as improved education for girls. This tension highlights the importance of designing WTO agreements in a way that is supportive of developing countries’ most pressing development needs.

Developing countries also need help with the analytical tools needed to allow informed participation in the WTO. Currently, the major industrial countries have the resources, in capitals or in Geneva, needed to evaluate trade offers. By contrast, developing country delegations are frequently unable to use data that are made available to them from the WTO for meaningful policy analysis. Current work by the World Bank and UNCTAD will help even up this situation by allowing developing countries to perform the same types of analyses. However, it is likely that trade ministries in many countries will need help from outside experts. If past practices on restricting the release of these basic data are followed, it will be much more difficult to help low-income developing countries assess the merits of particular proposals.

One of the key issues for WTO governance is whether it can continue to operate under the consensus principle for virtually all significant decisions. While this principle is very useful in safeguarding the interests of individual members, it seems likely to be too “conservative” to allow the institution to change. One option might be to distinguish between decision making and the formulation of positions around which a consensus might subsequently be expected to develop. The drafting process is already frequently undertaken using relatively small groups in so-called “green rooms”, but the rules for selecting the membership of these groups are very subjective, and some countries clearly felt left out in the cold at the Seattle Ministerial. One approach might be to develop a more formalized and transparent process for ensuring that such groups are representative of the countries concerned with the issue, and using these bodies as sub-committees for formulating and drafting initial positions. Proposals for a formal executive committee along the lines of the World Bank Board of Executive Directors have been floated (see Schott and Watal 2000), but have not found acceptance.

Another key area for reform at the WTO is the dispute settlement mechanism. This process needs reform, in particular, to shift the emphasis away from retaliation by the

complainant towards compensation by the party found to have violated its obligations. Raising trade barriers in order to retaliate against a country that has failed to meet its obligations is clearly counterproductive for the system as a whole. Further, it concentrates power in the hands of the largest trading partners. Thailand would certainly suffer if it were denied access to the US market, but the US would suffer much less if Thailand were to retaliate against it. Another important need for reform in dispute settlement involves the lack of determinacy about when a country has failed to meet its obligations.

Another priority for reform is increasing the transparency of the WTO process. This has two dimensions—internal transparency and external transparency. Internal transparency is clearly essential to allowing developing countries to participate fully in the organization. External transparency is important for allowing civil society to become better informed about options, and to build up support for worthwhile initiatives. A great deal has been done, particularly through posting information about country positions on the WTO web site. However, more could be done by making clear which papers have been temporarily restricted, and by making available additional material.

Conclusions

The world has been rapidly globalizing in recent decades. While this process appeared to hold broad support in the early to mid-1990s, it has recently come under sustained attack. Clearly, whether to continue this process has become very much a policy question, and one with enormously important implications.

One important feature of the globalization process has been a major shift in the nature of the trading relations between developed and developing countries. This shift, from dependence on exports of commodities, to much greater reliance on exports of manufactures and services, is sufficiently pronounced as to require rethinking of old approaches to viewing trade and development. It has also placed major pressures for change on the multilateral trading system as developing countries have become much more active participants.

After noting the sea-change in attitudes in developing countries about trade policy, we examined the changes that have taken place in developing country trade policies during the last two decades. This examination reveals that there has been substantial liberalization of all trade barriers in developing countries over the past 15 years. Tariff rates have been sharply reduced, as have foreign exchange rate distortions. The coverage of nontariff barriers has also been drastically reduced.

Over the same period, developing countries' trade has grown very rapidly, while the pattern of their exports has been transformed away from commodities and towards manufactured goods. This shift has taken place particularly rapidly in the high growth economies of East Asia, many of which have higher shares of manufactures in their exports than do the industrial countries. A dramatic increase in the share of manufactures in exports is observable even in some of the relatively poor countries of southern Africa that remain dependent on exports of commodities. This change has profound implications. Not only does it greatly diminish concerns about potential declines in the terms of trade, but it also puts much greater pressure on domestic policy makers to maintain a relatively open regime that will allow imports of intermediate and capital goods, and support production of manufactured goods for exports.

While the focus of trade policy reform must remain on autonomous, unilateral trade reforms and institution building, there is clearly a role for external engagement as a way to

combat the power of domestic vested interests, and to combat the adverse impacts of other countries' trade policies. The popularity of regional arrangements has increased dramatically in recent years, but there are good reasons to be concerned about the implications of this trend. Not only will the benefits of trade creation be largely offset by trade diversion, but the plethora of regional groupings under consideration will increase the administrative demands on already over-worked customs services.

The multilateral approach to external engagement has enormous advantages over regional approaches. In the major sphere where the multilateral system has been applied through a series of negotiations—trade in manufactured products—it has completely transformed the nature of trading relations. In the Uruguay Round negotiations that established the WTO, a framework that could potentially lead to substantial liberalization of agriculture and services was also introduced. The Uruguay Round also ushered in two major changes. The first was a dramatic increase in the size and coverage of the organization. The second was a sharp increase in the importance of positive integration measures that specify what members must do, rather than what they cannot do. These two changes have contributed to the serious difficulties encountered in initiating the next round of trade negotiations. Some reforms have been made to adapt to these changes, and more seem likely to be needed.

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Appendix 1.

Shares of Manufactures in Total Merchandise Exports

	%
Japan	98.1
Taiwan	96.3
Singapore	96.0
Hong Kong	95.9
Korea	94.4
Sweden	94.3
Finland	92.7
Austria	92.2
Italy	92.2
Germany	92.1
Portugal	91.4
China	90.7
Philippines	89.3
Bangladesh	89.3
Rest of Central European Assoc	89.0
Rest of South Asia	87.7
Switzerland	87.5
United States	86.8
Belgium/Luxembourg	86.3
Sri Lanka	85.9
United Kingdom	85.3
France	84.2
Malaysia	84.1
Thailand	83.2
Hungary	83.2
Mexico	81.7
Ireland	81.6
Spain	81.4
World Average	81.2
Turkey	79.8
Poland	77.4
India	76.8
Canada	76.5
Netherlands	73.6
Morocco	69.3
Denmark	68.4
Rest of World	62.3
Indonesia	62.1
Greece	61.8
Central America, Caribbean	61.0
Brazil	59.1

Vietnam	56.8
Uruguay	47.4
Rest of SACU (Namibia, RSA)	47.1
Former Soviet Union	44.6
Rest of North Africa	44.2
Argentina	39.7
Venezuela	37.7
New Zealand	36.3
Rest of EFTA	34.5
Colombia	33.6
Australia	32.1
Rest of Middle East	31.8
Zimbabwe	31.2
Other Southern Africa	25.5
Chile	24.3
Mozambique	19.6
Peru	18.3
Rest of Sub-Saharan Africa	17.3
Rest of South America	14.9
Rest of Andean Pact	14.1
Tanzania	11.8
Malawi	9.8
Zambia	9.7
Uganda	1.2
Source: GTAP 5 database.	