UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

FREE TRADE OR FAIR TRADE?

An enquiry into the causes of failure in recent trade negotiations

Mehdi Shafaeddin

No. 153

December 2000

DISCUSSION PAPERS

FREE TRADE OR FAIR TRADE?

An enquiry into the causes of failure in recent trade negotiations

Fallacies surrounding the theories of trade liberalization and protection and contradictions in international trade rules

Mehdi Shafaeddin

No. 153

December 2000

The author would like to thank a referee for his very useful and constructive comments.

UNCTAD/OSG/DP/153

Comments on this paper are invited and may be addressed to the author, c/o Editorial Assistant,* Macroeconomic and Development Policies, GDS, United Nations Conference on Trade and Development (UNCTAD), Palais des Nations, CH-1211 Geneva 10, Switzerland. Copies of *Discussion Papers* and *Reprint Series* may also be obtained from this address. New *Discussion Papers* are available on the website at: http://www.unctad.org/en/pub/pubframe.htm

---

* Tel. 022–907.5733; Fax 907.0274; E.mail: nicole.winch@unctad.org

JEL classification: F130, O140 and O200.

CONTENTS

Chapter		**Page**
I.	INTRODUCTION	2
II.	SUMMARY OF EVENTS	2
III.	FALLACIES IN THE PHILOSOPHY BEHIND UNIVERSAL TRADE LIBERALIZATION	5
	A. The foundation of theory of trade liberalization	5
	B. Unrealistic assumptions	6
	C. Perfect competition and constant return to scale	8
	D. Full employment and similarities between countries	11
	E. Explanatory power of the theory	12
	F. Alternative views on comparative advantage	15
IV.	FALLACIES SURROUNDING THE THEORY OF INFANT INDUSTRY PROTECTION	16
	A. Infant industry protection versus import substitution (Frederick List)	16
	B. Import substitution versus export expansion? (Raul Prebisch)	18
	C. Implementation problems	20
V.	CONTRADICTIONS IN THE GATT/WTO RULES	20
	A. Contradictions in design	20
	1. Agriculture	21
	2. Textiles, clothing and footwear	22
	3. Infant industry protection	23
	B. Contradictions in implementation of commitments	24
	1. Agreement on Textiles and Clothing	25
	2. Applying anti-dumping rules	26
	3. Differential treatment of developing countries	28
VI.	INTEREST OF DEVELOPED COUNTRIES	28
VII.	CONCLUDING REMARKS: TRADE NEGOTIATION AND DEVELOPING COUNTRIES	32
REFERENCES		35

FREE TRADE OR FAIR TRADE?

An enquiry into the causes of failure in recent trade negotiations

Fallacies surrounding the theories of trade liberalization and protection and contradictions in international trade rules

Mehdi Shafaeddin

United Nations Conference on Trade and Development

Abstract

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

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

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

I. INTRODUCTION

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

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

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

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

II. SUMMARY OF EVENTS

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

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

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

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

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

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

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