GENERAL AGREEMENT ON

TARIFFS AND TRADE

RESTRICTED

Spec(88)51
7 October 1988

ADVANCE COPY OF TEXT OF SECTION 3 OF THE SECRETARIAT'S REPORT
INTERNATIONAL TRADE 1987/88

The attached text is being given advance circulation so that it will be available for the Special Meeting of the GATT Council and the meeting of the Committee on Trade and Development, both scheduled for the week of 17 October.

This text of Section 3 of International Trade 1987/88 should be read in conjunction with Sections 1 and 2, advance copies of which were published at the end of July (see GATT Press Releases GATT/1437 and GATT/1438 dated 27 July 1988).

The attached text will be made available to the public when the printed version of Volume I of International Trade 1987/88 (currently being printed) is published.

88-1507

III. TRADE POLICY IN AN EVOLVING GLOBAL ECONOMY

The developments in merchandise trade reviewed in the first section of this report are generally encouraging. Over the past eighteen months the expansion of trade has been well above the average thus far in the 1980s, and it seems likely that 1988 as a whole will mark the second consecutive year of trade volume growth in the vicinity of 5 per cent. When it comes to 1989 and beyond, there is of course more uncertainty about the outlook for world trade. Given the range of unresolved issues mentioned at the end of the first section, it is safe to assume that output and trade will continue to be influenced by a mixture of developments affecting prices, employment and growth, as well as by the policy responses to those developments. It is clearly very difficult to make any long range predictions about the course of these developments.

While policy making is inevitably influenced by short-term considerations, it is important for decisions on trade policies to take into account to the maximum extent possible the underlying factors and trends influencing the evolution of the world economy. With this in mind, the following discussion considers very briefly the implications for trade and trade policy of two major longer-term trends which are generating pressure for structural changes in the patterns of world production and trade.

PRESSURES FOR CHANGE

Change is the only constant in the evolution of the modern world economy. It affects patterns of demand, output, employment and trade. Among the factors that generate pressure for change, two in particular - new technologies and diverging population trends - are shaping the future of world trade in important ways.

Technology is Globalizing Markets

There is little doubt that the world has entered a new stage of rapid technological progress. As is now widely recognized, many of the advances are based on the increasing use in production, organization, industrial design and marketing of new technologies based on microelectronics, an area which itself is constantly changing. By adding to the potential for responding flexibly to changes in demand at home and abroad and - together with innovations in other areas, including biotechnology, laser technology, optical fibres, energy and space technology - by promoting product innovation and product differentiation, the new technologies substantially broaden the scope for specialization and product diversification in international trade. In the process, they are also enlarging the services component of trade in goods.

These new opportunities for firms and countries are being enhanced by major advances in transportation which continue to reduce the cost of moving goods internationally. Recent progress in telecommunications is playing an even bigger rôle in shortening the economic distance between countries. Better and faster information is broadening markets and further internationalizing decisions on production, buying and selling. Modern telecommunications is also stimulating world trade by fostering the growth of international trade in services and worldwide capital markets.

At the enterprise level these changes are operating as a major factor in the internationalization of production and distribution within and between firms of different countries, and in the growth in the number of specialized small to medium-sized firms whose economic viability is critically dependent on worldwide outlets for their products.[1] At the level of the international economy, the changes are reflected in trends described in the first section of this Report, including the tendency for trade to increase more rapidly than national output, the diversification of exports into new products and new markets, and the emergence of new countries on the list of the world's leading traders.

Coupled with the competitive search for profitable investment projects, the new technologies are promoting the globalization of markets and greatly increasing the scope for international trade.[2] As a consequence, the costs of non-tariff barriers to trade, in particular quantitative restrictions, will be rising in tandem with the ongoing globalization of markets even if the level of non-tariff barriers remains constant.[3] The resulting loss of economic efficiency is particularly damaging at a time when the challenges posed by worldwide population trends make higher rates of economic growth in the world economy more important than ever.

Population Trends and Market Dynamics

The latest population projections by the United Nations indicate that the industrial countries are entering an era in which they can less and less afford the lower economic growth that accompanies blocked or delayed structural adjustment. Birth rates in several countries are already below the rate generally required to keep the population constant, and current projections are that the industrial countries will account for only 50 out of each 1000 new people added to the world's population during 1990-2010. Given these birth rate projections, and assuming no major changes in immigration policies, the industrial countries as a group are facing a future with essentially zero population growth, a gradually ageing population and a steady increase in the ratio of retired people to active workers.

The same population statistics point to an increase in the population in developing areas of nearly 50 per cent between 1990 and 2010, for a net increase of 1.4 billion. Labour force growth rates are, of course, more difficult to predict because labour force participation rates can vary. Granting this point, the predictions show a net increase of 55 per cent, or 600 million new workers in the developing areas between 1990 and 2010. This addition to the labour force in developing areas is nearly as large as the current populations of North America and Western Europe combined.

These developments have far-reaching implications for demand, production and world trade. The population figures suggest that for many goods and services the greatest potential for dynamic market growth in the coming decades will be in the developing areas. And since the types of goods and services demanded vary according to the income level and age of consumers, there are likely to be important changes in the composition of world output as well. As for the labour force projections, the combination of high rates of growth in the developing areas and little or no labour force growth in industrial countries is likely to affect the relative competitiveness of a broad range of industries.[4] Although the exact outcome of these various developments is impossible to predict, there is little doubt that the coming years will see continuing, perhaps even stronger pressures for adjustment in the patterns of output and trade in the world economy.

CHALLENGES FOR TRADE POLICY

The pressures for change discussed above pose direct challenges for trade policy, in particular, how to assist timely and continuous adjustment. In other words, are current trends in the trading system and in national trade policies likely to facilitate or impede ongoing structural changes in the world economy?

The multilateral trading system supports structural change and economic growth in the world economy in two ways. One is by promoting trade liberalization. The other is through the establishment of a framework of rules and disciplines for the conduct of national trade policies. By guarding against increases in tariffs (through the use of "bindings"), banning the use of quantitative restrictions save in exceptional circumstances and laying down provisions for minimizing distortions in competition, these rules and disciplines are designed to increase the stability and predictability of future trade policies and thereby promote trade-related investment. Trade-related investment, in turn, is central to the process of structural adjustment.

The trading system has not always carried out these tasks as effectively as its creators had hoped. Nonetheless, the value of the rules, and the commitment of governments to uphold the GATT system, is readily apparent forty years after the General Agreement came into force. The system has faced particular strains in the 1980s, mostly the result of macroeconomic policies, but also due to microeconomic policies.[5] Despite these strains (to which trade policy errors made their own contribution), there has been no major retreat into protectionism.

Recognizing the importance of reinforcing the rules of competition, furthering the process of trade liberalization and extending it to new areas of trade, GATT's member countries - which have increased in number by eleven since 1980, with six more in line for full membership - have embarked on the most ambitious and wide ranging round of negotiations in GATT's history. At the same time, this initiative reflects concerns over a rise in the number of trade disputes and a perception that, in the face of an adverse macroeconomic environment, the rules have not always been effective in preventing the spread of policies which obstruct rather than facilitate structural adjustment.

Discriminatory quantitative export restraints and increasing subsidization in agriculture are high on the list of current measures which threaten to undermine the multilateral trading system. More recently, there have been complaints about a more aggressive use of anti-dumping and countervailing measures.[6] It is largely the industrial countries which have been relying on these instruments to deal with protectionist pressures. In many developing areas, on the other hand, the trade regime is characterized by high unbound tariffs and import licensing, the latter being justified on balance-of-payments grounds, but often having substantial protective effects in specific industries.

With the growing linkages among economies, the costs of ill-conceived trade policies in developed and developing countries will continue rising. In particular, the distorted patterns of output and employment reduce opportunities for profitable investment and job creation.

The ability of the developing areas to create 600 million new jobs in the next two decades will require more success than in the past in mobilizing domestic savings and in creating conditions that will attract new net inflows of capital for productive investment. Successful trade policy reforms in developing areas, together with realistic exchange rates and an improved global trade policy environment, would contribute to this goal by promoting structural adjustment, which in turn would make these economies more attractive to domestic and foreign investors.[7]

For the developing areas to realize the full potential of such major reforms, it is essential that the industrial countries actively promote an improved trade policy environment. It should hardly be necessary to add that by responding positively to the pressures for changes in the patterns of production and trade, the industrial countries would be helping themselves as well.[8]

Among the leading candidates for policy changes that would increase national productivity in industrial countries while simultaneously increasing growth opportunities for developing areas are agriculture, textiles, clothing and steel (Box 4). Some adjustment has already occurred of course - high protection has not prevented important shifts in employment from these sectors to the rest of the economy. But their demands for continued special protection suggest that it is far from complete. As long as resources remain tied up in inefficient production and as long as consumers and users of protected intermediate goods are forced to pay above world market prices, the standard of living and competitiveness will continue to suffer. It is important, therefore, for governments to allow pressures for structural change to be translated into opportunities for faster growth in both developed and developing countries.

BOX 4 - THE TEMPTATION OF DISCRIMINATORY QUANTITATIVE RESTRICTIONS AND WHY IT IS SO DIFFICULT TO GET RID OF THEM

The spread of discriminatory restrictions is frequently the result of unresolved or delayed adjustment problems. A large majority of the known discriminatory restraint agreements involve the classic problem areas of agriculture, textiles, clothing and steel. In the case of textiles and clothing, most of the restraints were negotiated under the Multifibre Arrangement. The latest extension of the MFA was negotiated in 1986, a full quarter-century after the introduction of special "temporary" discriminatory restrictions on textiles and clothing.

These and other experiences suggest very strongly that such "solutions" to adjustment problems stemming from shifts in competitive advantage soon become part of the problem. Partly this is because quantitative restrictions not only grant domestic producers a margin of protection vis-à-vis foreign competitors, but also block the operation of the price mechanism (the alternative of non-prohibitive tariffs would allow the price mechanism to continue functioning). Even more important are two key features of discriminatory quantitative restrictions:

- Experience suggests that their availability is likely to increase the overall level of protection because governments face fewer constraints in taking action against imports of a product from one or a few countries than against imports of that product from all countries, including economically powerful trading partners. This increases the likelihood of protection being used when it is not really needed - in other words, that it will magnify adjustment problems or even create adjustment problems in situations where market competition was capable of ensuring orderly adjustment.

- Once in place, discriminatory quantitative restrictions are generally difficult to remove because they often build-up vested interests not only among the protected producers in the importing country, but also among the established producers in the exporting country or countries. Benefits to the latter group from such market sharing agreements include the opportunity to charge higher prices for the reduced volume of exports. Furthermore, such a system handicaps potential new competitors in the exporting country because of the difficulties they face in getting on the list of those who receive export licenses free of charge. With no multilateral requirements for digressivity or time limits, this greater staying power increases the likelihood that a discriminatory quantitative restriction will remain in place well beyond the transitional adjustment period envisaged when it was first put in place.

Together, these considerations help to explain why the most common result of using protection to deal with structural adjustment problems is that the adjustment is postponed rather than facilitated. In addition to making the ultimate adjustment more painful, delayed adjustment also reduces overall economic growth in the interim.

CONCLUSIONS

Most countries recognized a long time ago that maintaining trade barriers between provinces or regions within the same country would seriously handicap national development. For the market-oriented economies, a rule-based framework ensuring open competition between different regions of the country, coupled with a well-functioning domestic monetary system, played a central rôle in fostering economic growth.

There are, of course, important differences between national competition and international competition (in addition to the latter involving exchange rates, differences exist in such areas as financial flows and labour mobility). But these differences do not alter the basic point that as the proportion of national income accounted for by trade in goods and services increases, there is a growing need for the global counterparts of the domestic frameworks - the multilateral trading system and the international monetary system - to function effectively. These two basic elements of the international economic order provide the institutional framework which countries need in order to fully exploit the potential for economic growth created by technological advances. This is particularly important because these technological advances are greatly enlarging the scope for international specialization at a time when worldwide population trends indicate that higher economic growth is badly needed.

Growing interconnections between markets are also changing the way trade policies are defined. Already in the mid-1970s it was recognized that the definition of trade policies could no longer be limited to actions taken at the border, as is shown by the decision to include in the Tokyo Round such measures that can affect international competition as technical standards and production subsidies. Now, with international trade accounting for a steadily larger share of national income in most countries, and with the dramatic evidence in recent years of the extent to which trade flows can be influenced by a country's exchange rate policy, monetary policy, and fiscal policy (through the impact on the current account balance), the traditional distinctions between different policy areas are becoming even more blurred.

However we choose to define trade policy in these changing circumstances, one thing is clear. In many countries trade policy is becoming the single most important resource allocation policy, and as such is rapidly joining monetary and fiscal policies in the front rank of national economic policies. As a result, business and market confidence are increasingly influenced by perceived trends in trade policies and in commercial policy relations between countries. This explains why financial and stock markets now follow much more closely - and are much more sensitive to - trade and trade policy developments than was true even a few years ago.

The current multilateral trade negotiations can facilitate the process of structural adjustment throughout the world economy - first by coupling reductions in the levels of protection with increased market access abroad, and second by reducing business uncertainty through improvements in the functioning of the trading system. The result will be higher long-term economic growth. This is precisely what is needed to deal with the challenges posed by technological innovation and worldwide demographic trends.

FOOTNOTES

[1]These developments manifest themselves in a variety of ways, including direct foreign investment in production and distribution facilities, firm-to-firm agreements for joint production or marketing, increased foreign sourcing for equipment and intermediate inputs, mergers, technology sharing, licensing agreements and similar arrangements.

[2]Some forms of technological change can have an "anti-trade bias", as far as their direct impact on production technologies are concerned, in particular when they reduce the optimum size factory and thus reduce the importance of the economies of scale that go with access to large markets. However, even in these cases the introduction of new technologies frequently allows more product differentiation and flexibility in responding to changes in demand - both factors which foster the international exchange of goods and services. They also stimulate international trade through their impact on economic growth.

[3]As was noted above, the technology-induced globalization of markets means that foreign products become available in greater variety and at lower cost. Quantitative restrictions and similar non-tariff protective measures prevent consumers and user-industries from taking advantage of these opportunities. By insulating the domestic market against future developments abroad, these measures not only raise the prices of foreign products relative to their domestic substitutes (as do bound tariffs), but ensure that these price differentials will continue to rise as foreign products become cheaper. The export sector will also be indirectly affected by this process because international trade is a two-way street. Any action that reduces participation on the import side must ultimately lead to reduced participation in expanding world exports.

[4]Some forms of technological change appear to reduce the rôle of relative factor endowments in determining where products will be produced. In other cases, innovations can increase the rôle played by relative factor endowments by reducing natural impediments to international trade, such as transportation and communication costs.

[5]These included the poorest economic growth performance in four decades, serious debt service problems in a number of developing areas, high unemployment in many countries, historically large and persistent current account imbalances, very wide movements in exchange rates and the biggest upheaval in world stock markets since 1929.

[6]Whether the increased friction over anti-dumping and countervailing measures reflects the existence of a considerable amount of dumping and subsidization or the abuse of otherwise legitimate measures for protectionist purposes, these disputes are contributing to a perception that the trading system is not functioning in the way it was intended to by

its participants. Regarding the abuse of anti-dumping or countervailing actions for protectionist purposes, one major concern is the possibility that the initiation of such an action, or even the threat of an initiation, is used to get exporting countries to agree to market-sharing arrangements - that is, to the kind of discriminatory trade restraint arrangements mentioned above.

[7]For a number of poor and middle income developing countries, debt servicing burdens add to the challenges stemming from rapid population and labour force growth. Resolving debt-service problems in the absence of strong economic growth in an open world economy would mean primarily economic retrenchment, which would make it even more difficult for job growth to keep up with labour force growth.

[8]In the absence of a much faster rate of productivity gain in the industrial countries than that recorded in the past decade, the ageing of the population will imply a choice among lower levels of pensions and health care for retirees than are currently anticipated, sizeable cut-backs in other areas of government expenditure and increased taxes on active workers.