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To: Members of the Committee of the Whole on the Development Committee

From: The Secretary

Subject: Linkages Between Trade and the Promotion of Development

The attached paper on linkages between trade and the promotion of development has been prepared jointly by the staff of the Fund and the Bank as background for item 1(iv) of the Annotated Agenda for the April 28-29 meeting of the Development Committee. The Annotated Agenda (EB/CW/DC/83/1, 3/7/83) has been tentatively scheduled for discussion on Monday, March 28, 1983.

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March 7, 1983

Linkages Between Trade and the Promotion of Development 1/

1. Introduction

Over most of the postwar period, the world has experienced an almost unprecedented growth in output, incomes, and trade. For the world as a whole, trade has grown faster than output. For example, between 1963 and 1973 the volume of world merchandise trade grew at 8 1/2 per cent per year compared to a 6 per cent growth in world production (excluding services and construction). With much lower output growth in the eight years to 1981, the two rates moved closer together: 3 1/2 per cent and 3 per cent, respectively. This growth in output and trade was accomplished in the context of and in turn supported by a generally liberal trading environment. International trade negotiations, conducted under the auspices of the GATT, have resulted in substantial reductions in tariff barriers, particularly for manufactured goods.

The 1973-79 Tokyo Round of multilateral trade negotiations, while achieving further tariff reductions averaging about one third on manufactured products, was only partly successful with respect to nontariff barriers. Several new codes of conduct were agreed in areas such as subsidies, government procurement, and technical barriers to trade. No agreement was reached on the application of import restrictions for safeguarding domestic industries from injurious import competition. In the area of agricultural trade, while some tariffs were lowered and a few quotas and other restrictions on agricultural products were liberalized, agricultural protection remained, by and large, unaffected. Even in the nontariff measures where agreements were reached, the persistence of diverse national interests subsequently gave rise to controversy on the scope of application or interpretation of basic commitments. Furthermore, while the Tokyo Round of negotiations was under way, clothing and textile imports were further restrained under an extended Multifiber Arrangement.

The current recession has had global effects. In the industrial countries, real GNP growth slowed to just over 1/2 of 1 per cent annually in the past three years; in the non-oil developing countries, real economic growth averaged slightly over 3 per cent annually, barely keeping pace with average population growth. Exports grew by less than 2 per cent annually in the industrial countries. Export growth in non-oil developing countries was relatively robust, averaging some 6 1/2 per cent annually; even so, their aggregate current account deficit more than doubled on average in 1980-82 compared to 1977-79.

The slowdown in the growth of world trade was largely the result of the global recession, which also affected the various components of international trade. In 1980-81, the growth of trade in manufactures remained at about 4 1/2 per cent annually, compared to an average annual growth rate of 11 per cent in 1963-73; this relatively good performance

1/ A background paper prepared jointly by the staff of the Fund and the Bank.

was attributable to the developing countries' strong demand for manufactured goods. In contrast, trade in oil has fallen sharply, mainly due to reduced demand in the face of previous price increases and recession. The cyclical downturn has tended to depress both the volumes and prices of industrial raw materials in international trade. In agriculture, the effects of protection and recent large harvests have also tended to depress prices.

Slow economic growth in the last several years has triggered additional protectionist pressures in the industrial countries and has exposed underlying structural rigidities. Such pressures have also strengthened in developing countries, many of which face balance of payments difficulties. In some cases, they have responded to the immediate financial problems by restricting imports. Together, these developments have adverse implications for the growth of world trade. Protectionism and recession feed on each other. Prospects for international adjustment and future economic growth depend on the policies of both industrial and developing countries and their efforts to cooperate in addressing common problems.

The slowing down of growth in world trade and output, increased protectionist pressures, and the evolution to date of the multilateral trading system have far-reaching implications for both industrial and developing countries. Section 2 reports on trade policy developments in industrial countries. Section 3 analyzes trade policies in developing countries. Section 4 draws implications of the drift toward protection, while Section 5 indicates the roles of the Fund and the Bank in addressing the linkages between trade and development.

2. Trade policy developments in industrial countries

Protectionist pressures surfaced strongly in the industrial countries with the onset of the severe recession of 1974, and then again with the cyclical downturn that began in 1980. The spread of recessionary conditions worldwide constricted the possibilities of maintaining employment through increased export activity. Protectionist pressures were also associated with the underlying structural rigidities that were manifested in low levels of private investment, downward rigidity of real wages coupled with difficulties of retraining and relocating workers, and steadily increasing unemployment rates. 1/ Despite these pressures, most industrial countries avoided recourse to across-the-board trade restrictions, recognized as destructive of national and world prosperity and as most likely to incur the risk of triggering retaliatory actions. In June 1980, the OECD governments adopted a Declaration on Trade Policy, which affirms their intention to pursue policies that further the objective of an open trading system.

1/ Structural adjustment issues were examined in depth in the OECD Special Group of the Economic Policy Committee on Positive Adjustment Issues. See OECD, Positive Adjustment Policies, Final Report: Summary and Conclusions (Paris, April 1982).

Even so, sector-specific trade actions have multiplied in the industrial countries, particularly since 1980. With the general rise in protectionist pressures, the focus of policy appeared to shift from the objective of achieving a broad-ranging liberalization of nontariff trade barriers to the more modest aim of improving international discipline in the use of such measures. In addition, the medium-term economic costs of selective protective measures were often ignored; governments otherwise committed to liberal trade principles often opted for "temporary" actions that, in the short run, appeared to be least disruptive of normal trade patterns. Once introduced, however, such actions often served to trigger heightened protectionist demands elsewhere in the economy. Simultaneously, pressures grew on policymakers to modify the traditional stance of trade policy in accordance with the perceived "fairness" or "unfairness" of trade actions of trading partners. Consequently, piecemeal actions that limit or distort international trade currently affect a sizable proportion of world trade. The shift in trade policies, while not entirely accommodative of the intensified protectionist pressure, is still sufficiently important to give rise to concerns about the future direction of these policies.

The degree to which governments have responded to protectionist pressures by introducing restrictions, and the instruments used, vary considerably from country to country and from sector to sector. The textiles and clothing sector is of special importance for the non-oil developing countries, accounting for about a quarter of their exports of manufactures; in several developing countries, the textiles and clothing industry is the most important export industry and the largest industrial employer. Restrictions by industrial countries in this sector, first formalized under GATT auspices in the early 1960s, have become increasingly complex and more comprehensive as to products and producers covered by the restrictions. The recent GATT Ministerial meeting agreed to study the consequences of a possible phasing out of the Multifiber Arrangement and a return to normal GATT rules in this sector after the expiration of the present Arrangement in 1986. 1/ Given that protectionist attitudes have become firmly entrenched, liberalization of market access for the developing country suppliers appears difficult.

The recent drift toward protectionist policies has affected other manufacturing sectors as well. Although much of the trade in these sectors is conducted among the industrial countries, a growing number of developing countries possess an actual or potential competitive advantage in several of them. In the past two years, trade actions aimed at limiting import competition have affected the steel, automobiles, consumer electronics, shipbuilding, and footwear industries, while in certain other areas such as petrochemicals and high technology, trade frictions among industrial countries have tended to multiply as some governments

1/ The current restrictions, applied on a bilateral basis under the Multifiber Arrangement, are in effect a multilaterally negotiated derogation from the GATT framework of most-favored-nation treatment and avoidance of quantitative restrictions.

attempt to forestall competition from more efficient trading partners. Protectionist measures to slow imports through ad hoc administrative actions, or to promote exports through direct or indirect domestic subsidies, have proved difficult to identify or to dismantle. As in textiles and clothing, pressures to broaden the scope of existing restrictions to encompass new producers have proved difficult to resist.

Agricultural policies in the industrial countries are, in the main, directed toward the achievement of income and/or price objectives for the domestic farm sector; consequently, agricultural trade liberalization has not been a main policy objective with respect to imported farm products competing with domestic production in the temperate zones. The multilateral trading system, both in its rules and in their application, has in practice left agricultural protection outside the scope of the general negotiations that have reduced trade barriers on manufactured products. Protectionist actions with a particularly adverse impact on developing country suppliers have taken the form of import restrictions or levies, bilaterally negotiated export restraints, and export subsidies, and affect sugar, cereals, cereal substitutes, meat, and dairy products. The recently established GATT Committee on Agriculture is expected to examine "all measures affecting trade, market access, and competition and supply in agricultural products, including subsidies and other forms of export assistance." In the immediate future, however, there are risks that trade frictions in the agricultural sector may be exacerbated, particularly if export subsidies lead to disposal of surplus stocks on the international market on terms with which the relatively efficient producers cannot as readily compete.

3. Trade policies in developing countries

A wide variety of trade policies is adopted by developing countries--ranging from integration into the international economy to attempted isolation from it. Outward-oriented strategies are characterized by, inter alia, the maintenance of realistic exchange rates; the provision of similar incentives for domestic and export production; and the relative tolerance of import competition. In contrast, inward-oriented development strategies are typically characterized by protection against imports that extends well beyond infant industries; a bias in favor of import substitution and against export promotion; wide variation in degrees of import protection across industries; maintenance of overvalued exchange rates and negative real interest rates; and greater reliance on administered allocative mechanisms than on relative prices.

During the past two decades, an increasing number of developing countries, including the newly industrializing countries, have shifted to an outward-looking development strategy. These countries have generally fared better in terms of growth of output, incomes, and employment, and have also been able to adjust more rapidly to external shocks. In recent years, some developing countries facing renewed balance of payments pressures and continuing structural problems have returned to, or intensified, trade restrictions.

Experience with inward-oriented trade strategies as a means to rapid development suggests that such policies have most frequently not accomplished their intended results. On the contrary, the structure of of incentives provided, although fostering import substitution in infant industries, has tended to discourage export growth, thus undermining developing countries' capacity to take advantage of trade opportunities.

Many studies covering a wide spectrum of developing countries have concluded that establishment of relatively neutral incentives for the domestic market and for exports provides better prospects for faster growth than inward-oriented policies pursued through high protection. One such recent study which quantified this relationship for 43 developing countries concludes that a 1 percentage point increase in the rate of growth of exports is associated with a 0.15-0.22 percentage point increase in the GDP growth rate. Other studies have also shown that the form of protection extended also matters. Systems of protection which rely on administrative mechanisms such as controls and licensing tend to have more deleterious effects on resource allocation and development than protection through tariffs.

Although sometimes a view is expressed that outward-oriented development strategies would expose economies to larger external shocks than inward-looking strategies, economies that follow the former strategy have been found to be more successful in adjusting to these shocks. Studies of adjustment over the 1973-78 period (which included the quadrupling of oil prices and slowdown of growth in industrial countries) show the greater resilience of economies that have pursued an outward-oriented development strategy. Such developing countries, after experiencing a decline in annual average GDP growth rate from 7.3 per cent in 1963-73, were able to recover by 1976 to an annual average GDP growth rate of 7.9 per cent for the whole 1973-79 period. In contrast, developing countries that pursued inward-oriented strategies experienced a slower annual average GDP growth rate of 5.9 per cent over 1963-73; the growth rate fell to 4.9 per cent for the 1973-76 period, and did not rebound subsequently.

A number of reasons can be adduced for the resilience of these economies to external shocks and their ability to adjust their economies in order to resume their high growth paths. First, under the outward-oriented strategy, economies have greater flexibility as firms and other decision-makers exposed to competition acquire experience in pursuing strategies requiring adjustment in the face of external shocks. Second, countries that pursue outward-oriented strategies may have greater latitude to reduce import growth without disrupting production processes when faced with reduced demand for their exports or higher import prices. Under an inward-oriented strategy, imports are already restricted to "essentials"--often industrial inputs and machinery--so that further reductions become difficult without cutting total production. Third, outward-oriented strategies tend to encourage a more efficient allocation of resources owing to the low extent of discrimination in their economies against primary producing activities, narrower variation in incentives across activities, and cost reductions realized through economies of scale. Thus, although countries pursuing outward-oriented strategies may experience larger impacts on their payments balances than other countries, they tend to recover from external shocks faster, and the gains from their particular strategy outweigh the costs of adjustment.

Many developing countries have attempted to promote trade more actively among themselves within regional groupings and by other preferential arrangements. Trade expansion among developing countries occurring in the context of a reduced overall level of protection is likely to make a positive contribution to their development. If, on the other hand, it results from increased protection against third countries, it could have the same deleterious effects as protection at the national level.

Within the framework of the GATT, developing countries receive tariff preferences under the Generalized System of Preferences (GSP) and developing country members of the GATT are relieved of some of the obligations accepted by other members. Developing countries also receive favored treatment under the codes agreed in the Tokyo Round of multilateral trade negotiations. The impetus for special and differential treatment is, in part, related to the industrial countries' trade policies in general and to the limited access they offer to the developing countries for items such as textiles and agricultural commodities.

The GSP arrangements in fact cover a modest portion of developing country trade. About a tenth of developed country imports from those countries which are eligible for GSP benefits receive preferential treatment under the GSP; the tariff revenue foregone is of the order of $2 billion, only about 2 per cent of the value of dutiable imports from these countries. Many developing countries have criticized the erosion of their preferential margins resulting from the maintenance of unchanged preferential tariffs in the face of reduced most-favored-nation rates on the same products.

The conclusion that relatively low levels of protection and an absence of bias against exports is conducive both to longer-term growth and short-term adjustment has been recognized by many developing countries. As a result, over time many have reduced their effective rates of protection, in most cases unilaterally. Developing country markets are of growing importance to the industrial countries; thus, there is a valuable opportunity for mutual trade liberalization on the most-favored-nation principle that would help to secure open markets for the products of both industrial and developing countries. Such action would also help reverse the process of erosion in the adherence to liberal multilateral trade principles, with benefits for the stability of the trading system as a whole.

4. Implications of the drift to protectionism

The drift to protectionism has a number of adverse, interrelated consequences, both for the protecting country and internationally.

Structural adjustment and the efficient allocation of resources are impeded by protection. Measures to prop up ailing industries or preserve the incomes of the relatively less efficient producers through import restrictions and/or subsidization may well slow employment and income losses in the relevant sectors in the short run, but they are unlikely to raise the total level of employment. Restrictive trade policies reduce the incentive to adapt to movements in competitive positions arising from changes in consumer preferences, technological advances, and productivity gains, thus strengthening structural rigidities. The increased cost of protection is ultimately borne by the economy as a whole, through the higher prices paid by taxpayers or consumers and through the loss of income and employment opportunities in more efficient industries. Where the protected sector is a major intermediate goods industry, such as steel, the higher costs may be transmitted to other activities in the form of higher input prices. Moreover, the unprotected industries, particularly the users of the protected product, may well face an erosion of external competitiveness, generating further demands for protection. Thus, protection provides no real solution to the underlying problems of the protected sector, but often compounds the difficulty of finding lasting solutions. Similarly, reliance on trade restrictions for balance of payments purposes is not a viable alternative to more fundamental adjustment.

Protection has both trade-reducing and trade-distorting effects. Restrictive trade actions--whether in the form of import restrictions or bilaterally negotiated export restraints--directly reduce the ability of other countries to expand exports. Export subsidization leads to the displacement of more efficient producers abroad. This has been particularly evident in recent years in the agricultural sector, where high levels of domestic price supports have induced the production of surpluses which, in certain cases, have been disposed of in international markets at subsidized prices, thereby disrupting the markets of more efficient producers of both industrial and developing countries.

Under current conditions of world recession and severe adjustment problems of developing countries, the drift toward protectionism, if unchecked, poses particularly worrisome threats. First, it endangers the prospects for medium-term recovery of the world economy. Increased protection leads to loss of export markets by trading partners, and tends to feed back on the protecting country via reduced demand for its exports. Second, it compounds the balance of payments problems of the developing countries. Many of these countries face depressed commodity prices and external debt servicing difficulties. Their ability to generate increased export earnings would be limited if their access to foreign markets were curtailed. It would reduce their ability to service the debt and undertake new borrowing, which, in turn, would pose risks for the international financial system. For the relatively low-income developing countries, expanding trading opportunities provide an impetus for the transformation of their economic structures.

The form in which protectionist policies are applied can have additional implications. In the agricultural sector, domestic producers and consumers are often insulated from shifts in world supply and demand. As a result, adjustments are thrown on the international markets, thereby further disrupting these markets for the output of the more efficient producers of these agricultural products. This domestic insulation may be spreading to other markets: cyclical disturbances in the steel sector, for example, risk being "exported" to world markets. Measures which may not be explicitly restrictive (such as import surveillance or massive investigations into whether dumping or subsidization are occurring), may signal the future direction of trade policy; such measures, as well as bilateral deals to negotiate voluntary restraints or share markets, have an impact on third countries through trade diversion, and prompt other countries to offer compromises to preserve existing benefits, thus tending to "freeze" trade relationships and generating uncertainty that discourages or distorts investment decisions.

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At their meeting in November 1982, GATT Ministers undertook to "make determined efforts to ensure that trade policies and measures are consistent with GATT principles and rules and to resist protectionist pressures in the formulation and implementation of national trade policy and in proposing legislation" and to "avoid measures which would limit or distort international trade." They also agreed on a future work program. As already mentioned, the work program includes examination of the possibilities of reverting to normal GATT rules in the textiles and clothing sector and review of the measures affecting agricultural trade. It also seeks to "ensure the effective implementation of GATT rules and provisions and specifically those concerning the developing countries, thereby furthering the dynamic role of developing countries in international trade." While the declaration does not include a specific commitment to liberalize trade, it represents a renewed effort to strengthen the multilateral trading system. The challenge for the international community is to translate these intentions into concrete actions aimed at reversing the drift toward protectionism and achieving further trade liberalization. All countries have an important stake in the expansion of world trade that this would bring about.

5. <u>Role of the Bank and the Fund</u>

a. <u>The Bank</u>

As the primary institution for multilateral development assistance, the World Bank follows closely international development experience in all its facets. Its interest in a liberal and expanding international trade environment derives from the fact that such an environment is an essential ingredient for the rapid growth of developing countries and as an adjunct to the pursuit of outward-oriented development strategies. In that context, the Bank has continued to support, encourage, and foster a free international trading system through a number of vehicles. These have included macroeconomic policy advice to member countries, demonstration through analytical work, and support for export-promoting activities through lending operations. Similarly, in the procurement of materials for Bank-financed projects, international competitive bidding has been pursued as a cardinal principle.

In the current environment, when protectionist pressures have increased the Bank has mounted activities to support outward-oriented policies in the context of a liberal international trading system. The Bank's structural adjustment loans primarily support countries over horizons of 4-5 years to allocate resources consistent with their comparative advantage. Structural adjustment lending is linked to specific policy targets such as liberalization of the trade regime and a shift away from high-cost import substitution strategies to outward-oriented development strategies.

Given the close linkages that exist between trade and the promotion of economic development and the issues arising from recent developments, the Bank will conduct a broad policy dialogue with its member countries on these issues and support efforts by the Fund and the GATT in their endeavors to promote an open multilateral trading environment.

b. <u>The Fund</u>

A fundamental purpose of the Fund is to facilitate the expansion and balanced growth of international trade with a view to promoting economic growth; the Fund's activities, both in connection with its surveillance functions and its lending programs, serve to support this objective.

Fund surveillance in the context of its Article IV consultations encompasses industrial and developing countries alike, and is aimed at assessing whether members' policies are conducive to financial stability and economic growth. With the emergence of global payments imbalances and rising protectionist pressures in recent years, the Fund has undertaken to review trade policies more critically, particularly in its consultations with the larger trading nations.

It is well recognized that trade restrictions frequently reflect a failure to accept or encourage structural changes necessary for economic growth. Also, the maintenance of a restrictive exchange or trade policy may be symptomatic of an inappropriate exchange rate policy. These regular consultations provide an opportunity to assess whether a country's policies have adverse implications for other members or impede its own domestic adjustment. They also include recommendations for policy adjustments designed to bring about sustainable balance of payments positions and improvements in domestic resource allocation; the openness of the domestic market to international competition is frequently a crucial element of such policies. In this way, the Fund actively supports the leading role of the GATT in ensuring the maintenance and strengthening of an open multilateral trading system. In addition, formal and informal collaboration between the Fund and the GATT serves to encourage greater consistency between the exchange and trade policies of common members.

In the case of programs with members undertaking an adjustment effort supported by the use of Fund resources, a performance criterion on the introduction or intensification of trade restrictions for balance of payments purposes is generally included to ensure that the country does not achieve its balance of payments objective by using instruments that are detrimental to its own economy or harmful to its trading partners. Frequently, the objective of the authorities in undertaking a Fund-supported program is to bring about a shift toward a more outward-oriented development strategy. In these cases, trade policies are a key ingredient of the policy mix aimed at achieving the structural changes necessary to achieve balance of payments viability over the medium term. Often in cooperation with the Bank, the appropriate stance of trade policy is assessed, and recommendations for improvement in policy are incorporated in the program. Medium-term adjustment programs, and particularly those under the Extended Fund Facility, are specifically geared to provide members with balance of payments support for undertaking longer-term structural reforms. Furthermore, the confidence and assurance generated by Fund programs encourage the flow of financial resources from other sources, enabling the member to undertake orderly adjustment. Thus, Fund financial assistance directly and indirectly encourages trade policy reforms which augment the country's capacity to maintain open markets and compete efficiently with other exporters. The recent decisions to increase Fund quotas as part of a package of agreements which effectively double the Fund's usable resources will strengthen its ability to promote adjustment and contribute to the process of recovery.