

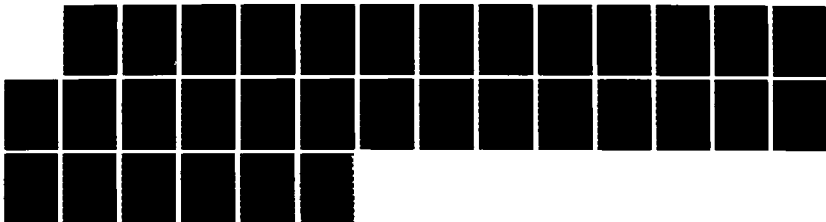
AD-A172 380

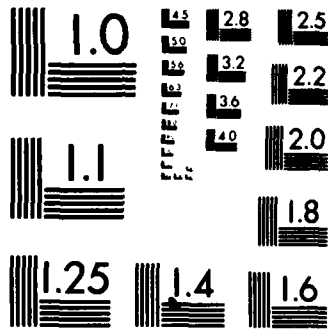
BARGAINING IN THE NEW ROUND: THE NICS (NEWLY
INDUSTRIALIZED COUNTRIES) AND... (U) DEPARTMENT OF STATE
WASHINGTON DC OFFICE OF EXTERNAL RESEARCH... H R NAU
06 AUG 86 FAR-112-86 F/G 5/4

1/1

UNCLASSIFIED

NL





MICROCOPY RESOLUTION TEST CHART
NATIONAL BUREAU OF STANDARDS 1963-A

1

FIAR-112-86

AD-A172 380

Bargaining in the New Round:
The NICs and the United States

by

Henry R. Nau
Professor of Political Science and International Affairs

Graduate Program in Science, Technology, and Public Policy
School of Public and International Affairs
The George Washington University

Final Report in Completion of Purchas Order #1722-620-112
for the U.S. Department of State

August 6, 1986

This paper was prepared for the Department of State as part
of its external research program. Views or conclusions con-
tained herein should not be interpreted as representing the
official opinion or policy of the Department of State.

SEP 17 1986
S A D

This document has been approved
for public release and its
distribution is unlimited

NTIC FILE COPY

86 0000007



Inspection For		<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
By		W. H. H. H. H.		
Distribution/				
Availability Codes				
Dist	Avail and/or	Special		
A-7				

Although the OPEC revolution received most of the attention in the 1970s, the real revolution in the third world occurred through the trade of manufactures and associated development and transfer of industrial technology. From 1960 - 1980, a small group of developing countries emerged from the pack of poor countries to achieve per capita income levels of \$2000 and above. Aside from the lightly populated oil surplus countries -- Saudi Arabia, Kuwait, and Abu Dhabi -- the key members of this new group of middle-income developing countries are the so-called NICs (newly industrialized countries) -- principally Korea, Brazil, Taiwan, Hong Kong and Singapore. Each of these countries relies significantly on manufactured exports for economic growth and development. In 1985, Brazil exported \$26 billion worth of merchandise, about two-thirds being manufactured goods. Korea exported \$30 billion, 95% being manufactured goods.

The NICs also include a second level of middle income countries whose growth depends more on domestic markets and commodity trade but whose manufactured exports began to grow rapidly in the late 1970s and early 1980s. These countries, sometimes referred to as the NECS (newly exporting countries), include Argentina, Mexico, India, Yugoslavia, Chile, Colombia, Malaysia, Thailand and Peru. Growing on a smaller base, their manufactured exports actually increased more rapidly in the 1970s than those of the principal NICs.

Ironically, despite this dependence and successful development through trade, many of these middle-income countries are the chief opponents today of a new round of comprehensive trade negotiations under GATT. Brazil and India oppose the inclusion in the new round of issues such as services, investment and intellectual property. They also demand as preconditions of the new round unilateral steps on the part of industrial countries to remove existing restrictions on trade in goods. While a few NICs or NECs such as Korea, Colombia and Chile are more favorably disposed to the new round, they are reluctant to confront their developing country colleagues and thus defer to the more hostile leadership of Brazil, India, Argentina and Yugoslavia.

What accounts for this apparent paradox between the real interests of developing countries in trade and their resistance to an improvement and expansion of the trading system? And how might this divergence be overcome to achieve a more meaningful participation of the developing countries in the upcoming trade round? Part of the answer lies in a better understanding of patterns of trade and technology transfer between developing and developed countries through various phases of the postwar period. These patterns reflect the relationship of the trading system to other important aspects of the world economy including the domestic policies of both industrial and developing countries, exchange rate policies, foreign investment and technology flows, and balance of payments lending. They also suggest the legacies that contribute to the current suspicions and in some cases misunderstanding that developing

countries harbor toward the multilateral trading system today.

Halcyon Days of the Trading System: 1950s and 1960s

When the trading system functioned most successfully in the 1950s and 1960s, few developing countries participated. Despite the membership of many Latin American countries in GATT, the immediate postwar period was marked by the prevalence of export pessimism and import substitution strategies in the developing world. Development strategists, led by the U.N. Economic Commission for Latin America (ECLA) and its Secretary-General Raul Prebisch, foresaw poor prospects for the traditional raw material and agricultural exports of developing countries and urged these countries instead to develop their own manufacturing capabilities through import substitution. While this approach was not entirely inappropriate, given the absence of significant industrial facilities in many developing countries, it was carried to the extreme and adhered to longer in most developing countries than was appropriate, especially in Latin American countries which started the period with more industrial capacity. From the late 1940s to 1960, for example, Brazil's exports did not grow at all, reflecting the total pre-occupation with import substitution and the domestic market. The only NIC during this period that opened its markets was Hong Kong, and its situation was in most respects unique.

Import substitution encouraged some foreign investment where this was permitted. It tended, however, to direct this investment and associated technology transfer into markets defined by elite consumption and previous import patterns. These markets were often characterized by high capital and relatively sophisticated technological requirements, rather than the low-cost labor and smaller, artisan-type manufacturing capabilities that

represented the comparative advantage of these countries. Moreover, in this period, only U.S. companies operated on any scale internationally. Thus, both the misdirected allocation of foreign capital and technology, caused largely by local policies themselves, and the relative monopoly of U.S. multinationals built up a legacy in developing countries of distrust and alleged exploitation by multinationals. This distrust reinforced the reluctance to open markets to foreign trade, because trade was seen as a precursor to foreign investment.

In the mid-1960s, a number of NICs, including Brazil, Korea, Singapore and Taiwan, shifted course and began to liberalize imports, unify and decontrol exchange rates and promote exports. These countries realized unprecedented growth rates. From 1960 -1973, Korea's exports expanded at a real annual rate of 14%, while its GNP grew at an annual rate of 8.9%. From 1968 - 1973, Brazil's exports and GNP grew in real terms by 13.6% and 11.2% per year respectively, while from 1965 - 1973, real annual growth of Singapore's exports and production was 12.6% and 12.7% respectively. By contrast, countries that continued to pursue import substitution policies grew much less rapidly -- Argentina by 4% per year in both exports and GNP, India by 3% per year, Chile by roughly 4%.

Brazil, Korea, and the other early NICs entered the trading system when other aspects of the world economy were most supportive of trade. Inflation was low and predictable in the key industrial countries. From 1950 - 1967, inflation in the United States averaged about 1% per year. Growth was moderate and steady. The United States experienced its longest period to date of economic expansion in the

1960s. Exchange rates were relatively stable, as much because of the underlying conditions of low inflation and moderate growth as because of the fixed exchange rate system established at Bretton Woods in 1944. Finally, the world financial system was, compared to later years, relatively small and stable. Many countries, especially in Europe and including Japan, imposed capital controls on international financial flows. Where capital exports expanded, they took the form largely of equity investments. The multinational corporation spread, especially among industrial countries (the period of the "American challenge" in Europe). Foreign investment was also attracted to the liberalizing NICs, but regulation and screening of foreign investment continued and even intensified.

Also in the 1960s trade stood at the top of the agenda of the international economic dialogue. The Kennedy Round from 1963 - 1967 reduced tariffs by an average of 50 percent across the board of internationally traded manufacturing goods. The world community focused on the real goods economy rather than the financial economy that came to dominate the international dialogue in the 1970s.

As Table 1 shows, the net result of these factors for the period from 1963 - 1973 was unprecedented growth in the volume of world exports and production. Overall rates reached 9% and 6% per year respectively, while manufacturing trade and output grew even more rapidly at 11.5% and 7.5% per year respectively.

Thus, the earliest NICs (and also Japan, which some analysts regard as the first NIC) shifted into manufacturing at the most favorable time in terms of the expansion of the world production and trading

TABLE 1
GROWTH OF WORLD MERCHANDISE TRADE AND PRODUCTION
(Average annual percentage change in volume)

	1963-73	1973-79	1979-84	1984	1985
EXPORTS					
<u>All merchandise</u>	<u>9</u>	<u>4</u>	<u>2</u>	<u>9</u>	<u>3</u>
Agriculture	4	3	3	4	-2.5
Mining	7.5	1	-4	3	-3
Manufacturing	11.5	5.5	4.5	12	5
PRODUCTION					
<u>All merchandise</u>	<u>6</u>	<u>3</u>	<u>1.5</u>	<u>5.5</u>	<u>3</u>
Agriculture	2.5	2.5	2.5	5	2
Mining	5	2.5	-3	2	-2
Manufacturing	7.5	3.5	2	7.5	3.5

SOURCE: GATT Secretariat estimates

system. The relative ease of their entry into the international trading system made it all seem quite natural and automatic. Without participating or contributing to the liberalization of trade (no LDC participated significantly in Kennedy Round tariff reductions), they were able to benefit from it. This experience may be a factor affecting the attitude of these countries today. While they know the benefits of trade, they do not recognize its obligations.

Troubled Decade for Trade: 1970s

Two economic shocks in the 1970s, one internal and one external, ended the halcyon era of the trading system. The internal one, relatively underemphasized in the subsequent analysis of this period, was the erosion of price stability in the key industrial countries, particularly in the United States. From 1967 - 1973, before the oil shock, the average annual inflation rate in the United States tripled over the period from 1961 - 1967. Through an overvalued dollar, the United States exported its inflation. The external shock, the oil price increases, added to domestic distortions and shifted the focus to finance and recycle of petrodollars. Trade receded from the international dialogue; commodity and financial issues ascended. Foreign investment came under attack (e.g. the various international codes and national regulations), even as it took a backseat to balance of payments lending and multinationals from Europe, Japan, and even some of the developing countries reduced the dominance of American firms on world markets. Developing countries once again shunned the trade liberalizing negotiations under the Tokyo Round and advocated an aid approach to trade in the form of special and differential treatment (preferences, etc.) for developing countries (preferences in effect shifting tariff revenues from developed to developing countries).

The unprecedented expansion of international financial flows, particularly through commercial balance of payments lending, fueled the continued expansion of international trade, especially for the oil surplus and newly industrializing countries. But this expansion now occurred increasingly on a foundation of weaker and less stable domestic conditions. As a result, exchange rate volatility increased and international debt obligations mounted. Table 1 shows that from 1973 - 1979 growth of world exports and production slowed dramatically to one-half or less of the annual growth rates of the 1960s.

The original NICs -- Brazil and Korea -- reacted to these shocks in contradictory ways. On the one hand, they accelerated their emphasis on manufactured exports to sustain growth and pay for higher priced oil imports. On the other hand, however, they reversed their earlier policies of liberalizing imports and decontrolling exchange rates. Korea and Brazil extended import substitution policies to heavy and capital goods industries, justifying such policies by the need to diversify exports and reduce import requirements (particularly capital goods requirements which had grown substantially as a result of the first wave of import substitution policies). The net result was to raise dramatically the costs of export-led development and to exacerbate domestic distortions already created by the higher costs of energy.

Belatedly, subsequent NICs or NECs -- Mexico, Argentina and Chile -- shifted to export-led growth in this period. Their policies, however, were even more compromised by legacies of import substitution and greater historical reliance on commodity as opposed to manufacturing trade. Their experiments in outward-oriented growth were short-lived and relatively unsuccessful.

Thus, the energy crisis of the 1970s affected the trading system in two important ways. It necessitated overnight a massive expansion of international financial, especially commercial bank, lending. International lending in turn, drove the expansion of trade and, to a lesser extent, foreign investment, especially between developed and oil surplus and newly industrializing developing countries. At the same time, the energy crisis compounded inflation and encouraged trade restrictions, both of which substantially increased the misallocation of domestic resources in industrial as well as developing economies. The easy availability of finance diverted attention from the need to restore more efficient domestic policies and to emphasize market-opening trade negotiations. Finance came to be regarded as the solution to energy problems. Yet finance undoubtedly drove trade in the 1970s, especially between developed and developing countries, beyond the point justified by existing domestic economic conditions and comparative advantage.

Adjustment Exacerbates Trade Problems: Early 1980s

The policy directions of the 1970s in both industrial and developing countries were unsustainable. Pressure for adjustment came after the second oil crisis in the form of contractionary monetary policies in the key industrial countries and spiraling interest rates and debt burdens in the developing countries. External finance dried up. With this factor gone, which had driven trade and growth in the late 1970s, world trade and growth slowed even further. As Table 1 shows, annual rates for both slumped to 2% or less.

Reactions to these developments in both industrial and developing countries have put enormous stress on the trading system. Adjustment policies have shifted costs to the external sector, severely restricting trade flows.

In the United States, initially tight money and continuing loose fiscal policy produced an historically unprecedented high dollar, which made foreign imports more competitive and U.S. exports less competitive. Traded goods sectors in the United States underwent severe contraction.

Developing country policies exacerbated these developments. Reacting to the interest rate shock, heavily indebted developing countries, which include most of the key NICs, drastically cut imports. Average import growth in these countries dropped from a plus 30% per year in 1978 - 1981 to a negative 7% per year in 1981 - 1984. From 1981 - 1984, these countries cut imports by a total of \$43 billion, 40% of this amount or \$16 billion with the United States alone. U.S. exports to Brazil dropped by \$1.2 billion, to Argentina by \$2.1 billion, and to Mexico by \$9.6 billion. U.S. exports to Korea stagnated even though Korea increased overall exports by 10%.

Recovery in the United States after 1982 restored growth to developing country exports. From 1981 - 1984, exports of the high-debt developing countries to the United States rose by \$15 billion, increasing the U.S. share of exports from these countries from 25% to 32%. Exports from Brazil increased by \$3.5 billion or 85%, from Korea by \$5 billion or 90%, and from Chile by \$450 million or 75%.

The slower pace of recovery in the other industrial countries put the primary burden of absorbing developing country exports on the United States. Today, the United States takes in 68% of all manufacturing exports of developing countries, up from 52% in 1981. Meanwhile, Europe accounts for only 24% down from 40% in 1981; Japan's share remains unchanged at 7%. This imbalance among industrial countries has exacerbated the protectionist pressures in the United States, further straining the stability of the international trading system.

These abnormal pressures on the trading system may have been worth the price if they had been accompanied by improvements in domestic policies and conditions, the foundations for sound international trade as evidenced in the 1950s and 1960s. Some improvements have been achieved, most impressively in the inflation rate among industrialized countries. Inflation in the OECD countries is expected to be less than 3% in 1986, helped along in the past year by unexpected oil price declines. Investment and growth in the OECD countries have also been revived. Real growth in the five major industrial countries averaged 3% in 1983, 4.2% in 1984, and 2.8% in 1985.

Nevertheless, serious distortions and rigidities remain in OECD economies. The U.S. fiscal deficit persists, while fiscal conservatism continues in Europe and Japan. Under these circumstances, sustained growth relies increasingly on rapid money growth and political pressures to lower official discount rates. Inflation has been accelerating for a couple of years in the service sector, and food and energy prices cannot be expected to sustain the declines of recent months.

If domestic conditions in the industrial world are still troublesome, inflation and inefficiency in the developing countries remain alarming. Despite the emphasis on adjustment and IMF programs of recent years, the newly industrializing countries, with the exception perhaps of Korea, have made few improvements in the flexibility and efficiency of their home markets. The median domestic inflation rate in the heavily-indebted countries increased from 17% in 1982 to 33% in 1984. Instead of adjusting to meet fiscal and monetary targets of IMF agreements, indebted countries have negotiated a series of adjustments to the IMF agreements. Brazil alone has signed seven letters of intent with the IMF since 1982. The adjustments that have occurred have come almost exclusively through trade rather than domestic policy. In 1985, as the GATT Secretariat notes, the heavily indebted countries, again including the principal NICs -- Brazil, Korea, Argentina, Mexico, Yugoslavia, Chile, Colombia, etc. -- "returned to the import-contracting adjustment that characterized their performance in 1982 and 1983." Exports in only five of these countries increased, while imports in thirteen of them declined. As growth slows and protectionism increases in industrial markets, the NICs restrict imports even more, thereby magnifying further their own domestic distortions and inefficiencies while also fanning additional protectionist sentiment in industrial markets.

U.S. Policy Options

The incomplete adjustment in both industrial and developing countries presents the United States with new choices:

- Should the United States give priority to further macroeconomic adjustment in both groups of countries? This would imply renewed efforts to reduce the U.S. budget deficit (which may be necessary in the wake of the Supreme Court decision striking down Gramm-Rudman), stimulate growth in Europe and Japan, and press stabilization and structural reform programs in the developing world.

- Should the United States shift policy priorities to international financial and monetary reforms, as it appears to have done in the past year or so? This implies continuing efforts to lower the dollar, coordinate international economic and exchange rate policies and mobilize new financial resources (Baker Plan) to alleviate debt servicing constraints or perhaps even, as Senator Bradley has recently suggested, to write down some portion of the outstanding long-term debt of developing countries.

- Should the United States pursue more aggressively the multilateral liberalization of trade policy as the central priority of international economic strategy in the last half of the 1980s? This would imply both a willingness to bargain with Congress for new flexibility and authority to negotiate in the upcoming multilateral trade round and a readiness to subordinate bilateral and plurilateral trade actions and negotiations to multilateral objectives in the new round.

These directions for U.S. policy are by no means exclusive of one another. Yet the priority accorded among them is critical. In its first term, the administration clearly gave priority to domestic macroeconomic adjustment, even at the expense of a considerable shock to the world's financial and trading system. Since 1985, the administration has given more emphasis to international financial and monetary reforms. Throughout this period, the United States has been more defensive toward trade policy, resisting rhetorically protectionist pressures but conceding to these pressures increasingly in practice and since 1985 pursuing a more aggressive bilateral and plurilateral policy toward both trade liberalization (Israel, now Canada, maybe ASEAN) and threatened trade retaliation (e.g. 301 actions against Taiwan, Korea, Brazil, etc.). The less aggressive support for

multilateral trade liberalization has been not only understandable but probably inevitable given the earlier preoccupation with domestic adjustment and lingering problems with the high dollar and debt constraints.

Today, however, the opportunity to give multilateral trade policy a higher priority in U.S. economic strategy may be greater. On the surface at least, the world's financial and monetary situation is considerably improved. The dollar is down, and the world community has finally reached the point, in the absence of short-term emergencies, where it can consider the longer-term management of the debt crisis. If U.S. initiatives over the past year toward exchange rates and debt financing has helped to achieve this outcome, they have been well targeted. On the other hand, these initiatives may have run their course. A further decline of the dollar is now resisted by both Germany and Japan, and the dollar's decline thus far has not helped the United States a great deal with some of its major trading partners, especially the key NICs whose currencies are tied to the dollar. Moreover, it is not yet clear whether underlying economic conditions have improved as much as the financial indicators. There are few signs that further fiscal policy adjustment has been achieved in the United States or in other industrial countries, and the emphasis on more financing for indebted countries may have turned their attention away from further adjustment just when its continuation was most needed (judging at least from the growing resistance among these countries to IMF agreements and the slow development of an acceptable and effective role for the World Bank in structural policy reform).

In these circumstances, giving new priority to multilateral trade liberalization may be helpful both to sustain the emphasis on adjustment,

which is necessary albeit politically difficult, and to open up new opportunities for renewed capital flows to developing countries.

Adjustment thus far has been pursued primarily in a bilateral context under the aegis of IMF surveillance and adjustment programs. In this context, it has become increasingly politicized and in any case has not been particularly conducive to trade liberalization. In the winter of 1984-85, for example, the IMF Director approached the United States and other industrial countries worried about the reluctance of developing countries to liberalize trade in the context of IMF programs. He asked if the industrialized countries would be willing to reciprocate for trade liberalization measures that the developing countries might adopt unilaterally, thereby encouraging the latter to take such measures. For various reasons, including institutional difficulties between the GATT and IMF, the proposal could not be implemented.

Similarly, the World Bank has sought to encourage greater trade liberalization, but its efforts too have fallen short. The Development Committee, at its session in April 1985, featured trade issues for the first time. In the absence of an appropriate bargaining framework, however, the United States opposed any reference in the communique to textile trade. Developing country interest in the new round declined accordingly, and the Development Committee shifted its focus in April 1986, in the wake of the Baker initiative, back to the familiar ground of development finance. The communique in 1986 did affirm the concept of a "trade credit" whereby developing countries would receive credit in the GATT round for unilateral steps they might take to liberalize trade on their own. Nevertheless, it is hard to conceive how such a trade credit might be implemented, especially when the World Bank, which would monitor such measures, has no country

dialogue with industrial countries.

The new GATT round offers a way to move an important element of adjustment policy, namely trade policy, out of the bilateral context, where it has languished, into a new multilateral arena where countries exchange real concessions in trade and do so without the adversarial monitoring of international bureaucrats. The Fund and Bank could then reinforce the participation of developing countries in the new round by offering financing in support of trade liberalization where it may be expected that imports of developing countries will expand more quickly than exports. In the end, trade liberalization itself may become the biggest factor catalyzing once again new flows of financial resources to developing countries. As the World Bank emphasized in its background report for the 1985 Development Committee meeting, "trade liberalization would improve the prospects of indebted countries by encouraging the supply of direct investment and commercial bank funds to export-oriented industries."

Thus, a more aggressive U.S. policy toward the trade round fits in well with the administration's financial objectives toward the indebted countries and sustains an emphasis on policy adjustment, particularly in trade policy where developing countries' attitudes remain most difficult to change.

NIC Policy Choices

The strategic policy choices for the NICs are two-fold:

- to persist in the trade restricting policies of the past four decades and extend them into new areas of information and communications technologies.

-- to alter fundamental attitudes toward the trading system and progressively liberalize imports in exchange for enlarged and more secure access to industrial country markets.

The first choice assumes that the international trading system will continue to accommodate NIC exports and the international financial system will continue to finance the higher costs of protected domestic development. Neither assumption is likely. But, even if they were, the NICs would derive less benefit from this approach in the future than they have in the past. The reason has to do with the increasing incompatibility of restrictive trade policies and integrated world markets for protection, technology and trade.

Trade has become increasingly linked with international production. GATT estimates that some 40% of world trade is now intra-firm trade. Trade in services, it is argued (though the statistics are still missing), is also closely linked with investment. While this fact raises old fears of multinational and restrictive business practices in some developing countries, it actually reflects the increasing competition among multinationals and the growing prevalence of joint ventures and decentralized management of multinational networks of affiliated firms and subsidiaries. Multinational expansion today involves a more significant sharing of technology and financing with foreign partners than was the case before.

This sharing is a direct consequence of the accelerating pace and diffusion of technological change in world markets, the collapse of the product life cycle. National firms can no longer hold a competitive

technological advantage long enough to export products from the home to foreign markets; they must immediately seek joint arrangements to produce and market the product abroad, even in some cases to design and develop the product initially in collaboration with foreign partners.

These developments create an entirely different world market for trade, investment and technology transfer. Under the obsolete product life cycle, products were designed for home markets and then sold and produced abroad as non-technological factors, such as transportation costs and wage rates, affected competitiveness. Today products are designed with foreign markets in mind. Chances are considerably greater that these products will reflect local factor endowments and demand requirements. Second, multinationals are now more numerous and competitive than before. They are forced to sell and produce abroad more quickly, or lose their markets not just to local producers as in the past, but also now to third country multinationals. Host countries enjoy enviable bargaining leverage. Third, access to foreign markets is increasingly critical not only to sell and produce products but also to keep pace with technological change and to acquire or share technology in these markets as needed.

The range of technological change in world markets is also broadening. Today new production technologies are as important as, if not more important than, product technologies. Flexible automated manufacturing systems reduce production costs for labor-intensive products such as apparel and footwear, while permitting more efficient production of capital-intensive products for smaller markets or niches in larger markets, such as the luxury end of the automobile market. These developments alter in some ways the traditional

comparative advantage of less developed countries in labor-intensive products and of industrial countries in capital-intensive manufacturing sectors. They make it less likely that developing countries will produce only lower end technology items or that industrial countries will lose their manufacturing sectors altogether.

There are two schools of thought as to how a country exploits these new features of world markets. One is to manipulate domestic and trade policy to target technology, investment and trade in specific products. The other is to open markets and let the greater forces of competition determine comparative advantage, trade and investment flows.

The first is possible in a country that has a reasonably coherent policy-making process or large domestic savings (the latter being necessary because mistakes in this more centrally steered approach are costlier). Japan is considered to have both, Korea also to a lesser extent. Even then the sustainability of this approach is limited by the tolerance of trading partners. The second is more congenial to a country with a competitive policymaking process or lower domestic savings. The United States reflects these characteristics as do many developing countries, especially those undergoing recent democratic changes.

Nevertheless, developing countries hesitate to open their markets to greater competition, fearing that they lack sufficient entrepreneurial capabilities to hold their own in domestic, let alone world, markets and determined to protect their natural resources, industrial assets and national sovereignty. In rapidly changing world markets, these attitudes are a prescription for falling farther and farther behind. Import substitution or,

as they are now called, market reserve policies condemn the home country to accelerating technological backwardness as technological change in world markets moves faster than technological catch-up in protected markets. What is more, such policies raise costs to domestic users of protected products and thus impair the competitiveness of a wide range of manufacturing and export activities. This makes it unlikely that the country can ever attain competitiveness in world markets even if it succeeds in "reserving" a large share of the home market for its own industries. Countries with small home markets are at an even greater disadvantage.

In many ways, the lead-in to the growing integration of world production and technology is freer trade. Countries that do not trade with one another also do not invest or transfer technology with one another. The United States and Japan, which import more manufactured goods from developing countries than Europe, have closer manufacturing and technology relations with these countries than Europe. The NICs need to consider whether they can remain a part of an increasingly integrated world market if they restrict trade and in turn cut themselves off from global technological change.

II. Bargaining in the New Round

World market developments therefore offer both the United States and the NICs a new opportunity to emphasize international trade liberalization talks. In November 1985, the GATT Contracting Parties established a Preparatory Committee to launch the new round. That committee has met eight times through the end of June. It hopes to complete its work by July 19 and submit the results to the GATT Ministerial Meeting in Punta del Este, Uruguay in September.

The issues in Geneva have been defined by the tabling of two draft communiques in the Preparatory Committee -- one by a group of 10 developing countries led by Brazil, the other by a group of nine industrial countries led by the members of the European Free Trade Association (including behind-the-scenes collaboration with the United States, though the latter is not formally a sponsor). The issues are threefold:

- can the industrial and developing countries agree to expand the GATT to include new sectors such as services, investment and intellectual property?
- if not, can they strengthen the existing GATT system for goods and possibly agriculture, including safeguards, non-tariff measures, etc.?
- if they can do neither, is the alternative world of bilateral and regional trading arrangements a viable alternative for either industrial or developing countries?

To resolve any of these questions, the two sides must be ready to bargain. Thus far, the developing countries have given no hint that they understand the GATT process of reciprocal bargaining. Historically unused to assuming obligations, they demand concessions rather than offer propositions. The United States, on the other hand, is also reluctant to bargain, at least until after the current election season. It insists that the GATT be expanded but is unwilling to specify the price it is willing to pay in strengthening the GATT, particularly in products of special interest to the NICs.

Without expanding the GATT, it is doubtful that the round can be launched or, if it is, that the GATT can be strengthened. And if the GATT can be neither expanded nor strengthened, trade talks will devolve to bilateral and

plurilateral arrangements where substantive trade-offs will be made in any case. So the issue is not whether to bargain, but where and when. The NICs can strike a better deal in GATT than outside GATT. And the United States is better off bargaining now to ensure an auspicious beginning for the new round.

Expanding the GATT

Brazil, India, Argentina, Egypt and Yugoslavia currently lead a group of developing countries strongly opposed to the inclusion of new issues in the GATT round -- services, investment and intellectual property. They argue instead for a standstill and rollback of all trade restricting measures on manufactured goods (textiles, steel, footwear, etc.) and agriculture -- sectors which are clearly within the existing jurisdiction of GATT. They argue further for a tightening of the safeguard rules in GATT to prevent future derogations from GATT.

The United States accepts a standstill and rollback of trade restrictions in goods and agriculture and has argued that everything should be on the table in the future trade round, including the U.S. Section 22 waiver on agriculture. Nevertheless, the United States is unwilling to accept preconditions for the negotiations and argues that issues of interest to all countries should be included.

The United States prefers a procedural compromise -- an agreement to discuss all issues in the new round. If this does not succeed, it threatens to negotiate with like-minded countries hoping to draw reluctant countries into the process at a later date. A third possibility, to agree now to broad

parallel commitments to phase out restrictions on goods and agriculture and to undertake negotiations on services, intellectual property, etc., has not yet been posed.

The opportunity to do so may arise in the next few weeks. As the developing countries press the United States on the details of a standstill and rollback commitment, they put the United States on the horns of a dilemma. The United States is being asked to refrain from unilateral or bilateral trade actions that it is using with greater frequency and that Congress is pressing it to use even more. It will be difficult, in any case to gain Congressional approval for such self-restraint. But the administration is certain not to gain such approval if the developing countries refuse to place the new issues on the agenda. Yet the Brazilian-led draft communique does not mention services at all and the possibility of a bargain seems remote if not alien to developing country attitudes.

The issue for the United States is whether a meaningful standstill and rollback commitment would apply to existing U.S. restrictions in sugar, meat imports, textiles, steel, automobiles, etc. as well as the use of future 301 actions in both goods and services trade. Ideally, the United States would like this commitment to apply only to new measures, not existing restrictions or extensions of existing programs (such as another VRA in steel or tightening sugar quotas under existing programs). According to U.S. interests, it would not apply at all to trade legislation consistent with GATT (201, CVD, and AD provisions and national security), and it would mean submitting 301 cases to GATT but only in goods. In new areas -- services, etc. -- the United States

would remain free to retaliate under 301, including retaliation in goods areas, without submitting to GATT rules.

The more the United States is pressed to define standstill and rollback, however, the more it reveals its inability to include issues of real interest to the LDCs. Under these circumstances, Brazil and the hardliners, which have lost ground in recent months, may gain support once again among moderate developing countries to exclude issues of real interest to the United States -- services, etc.

What needs to be done in this situation? For their part, the NICs need to recognize that including new issues is a bargaining (and not a theological) matter. They should use it to secure the clearest possible commitment from the United States to standstill and rollback. The United States, in turn, should consider the broad "framework" compromises it must make now with both Congress and the developing countries to launch the new round under the most favorable circumstances. It might accept a firm commitment against any new bilateral or plurilateral trade actions in goods (i.e. agree to take all 301 actions in goods to GATT) and agree to negotiate a rollback of existing restrictions by a certain date (e.g. by 1989 when both the current steel agreements and possibly the new MFA will expire). If it could secure a date for completion of service negotiations, it might even accept a standstill on 301 actions in services sectors, at least in those sectors given priority in the trade round. This commitment could be made for one year, renewable if the services negotiations warranted it. The more the developing countries give in services and other new sectors, particularly intellectual

property, the more carrots the United States should offer by way of restraining its actions outside the GATT. In this way, the United States makes compromises that Congress has a better chance to accept. Services exporters and many traditional industries, which have a stake in intellectual property rights, will support such a compromise. And, even within a traditional sector such as textiles, an agreement to negotiate on counterfeiting and intellectual property rights may offset to some extent the commitment to negotiate a long-term phase-out of quantitative restrictions.

Strengthening the GATT

If the GATT round begins with broad commitments such as those outlined above, strengthening the GATT becomes easier. On the other hand, without such commitments, there may not be a sufficient balance of benefits within the GATT issues themselves to warrant compromise.

The key issues involved in strengthening the GATT are safeguards, tariffs, nontariff barriers, agriculture and dispute settlement. All of these issues require some give and take on both sides. But the benefits are insufficiently balanced to encourage compromise individually or collectively among these issues.

On safeguards, for example, the NICs ask for strict adherence to a nondiscriminatory and strengthened Article XIX. In return, the United States asks for greater discipline by developing countries under Article XVIII, which gives developing countries broad discretion to impose quantitative restrictions for balance of payments and infant industry

purposes. The European Community seeks to amend Article XIX to allow discrimination or selective application of relief against offending exporters only. It is doubtful that firmer adherence to Article XVIII by developing countries offers enough either to the United States to rollback textile restrictions or to the EC to drop its demands for selectivity, especially when developing countries retain high existing levels of protection on most of their imports.

Thus, the safeguards issue blends with the issue of tariff reductions. In this area, the industrial countries are not likely to have much to offer, since their tariffs are already low. To secure the basis for compromise, therefore, the industrial countries would have to throw in nontariff measures or quantitative restrictions. They might convert quantitative restrictions to tariffs in such sectors as textiles, steel and leather goods and then proceed to bargain reciprocally to lower tariffs in developing countries.

As high as they are, however, tariffs are not the only or even main restraint on imports in developing countries. Subsidies, licensing policies and other administrative measures are frequently more important. The United States has long sought to bring the NICs under the provisions of the subsidy code, offering in return the injury test for U.S. imports from developing countries. In many cases, however, this incentive was not enough. If, on the other hand, export subsidies for agriculture as well as industrial products are included, the developing countries acquire a much broader incentive.

In this way, the subsidies issue blends with the larger and very controversial agricultural issue. But now the European Community is put on the spot. Within the export subsidy area alone, it does not have sufficient incentive to reach a compromise. And so the Community advocates a separate negotiating group on all aspects of agricultural policy arguing that protectionism is a problem in all countries not just those subsidizing exports.

Finally, the issue of dispute settlement reflects overall willingness of the GATT members to submit to GATT disciplines. This willingness in turn, is a function of the overall benefits of GATT participation. If those benefits are inadequate, countries will circumvent GATT. This, it may be argued has become the biggest reason for expanding the GATT and also for liberalizing agriculture.

Bilateral and Plurilateral Alternatives

If the basis for broadening the benefits of GATT membership cannot be found, trade disputes and solutions will devolve to a bilateral or plurilateral context. Trade-offs will be made in more constrained and possibly more coercive circumstances. The issue for the United States and the NICs, therefore, is whether they prefer to negotiate these disputes in the multilateral trade round or in bilateral and regional relations. To this point, the NICs have shown a decided preference for negotiating bilaterally. That explains their acceptance of the MFA in practice even while they denounce it in theory. They like the economic rents they gain from these restraint arrangements and the political assets they can turn to their advantage in bilateral situations (e.g. Korea's security value to the United States).

Under pressure from Congress, however, the administration is beginning to push its weight around in bilateral trade relations. If individual trading partners are ready to negotiate services, the United States is offering broad free trade area negotiations. This is the case thus far with Israel and Canada. However, with those partners unwilling to negotiate services or reciprocate in goods trade, the United States is using the big stick. 301 actions against Brazil, Taiwan, and Korea, discretionary graduation of these same countries from GSP in specific product areas, and more restrictive bilateral arrangements under the current MFA renewal -- all suggest that U.S. bargaining power in the bilateral context is being used more aggressively and with fewer residual benefits for the NICs.

Japan, although not a NIC in the terms of this paper, has already recognized the need to seek refuge from U.S. bilateral badgering in the more diffuse setting of multilateral negotiations. Will the NICs follow suit? They do not have an unlimited amount of time to make their decision. While, for some U.S. policymakers, the aggressive use of bilateral and regional arrangements has always been a tactic to compel greater interest in multilateral negotiations, the longer the tactic persists and multilateral negotiations stall, the more likely the trading system will devolve into a set of individual, albeit overlapping, trading arrangements in which reciprocity with the NICs will be negotiated bilaterally rather than multilaterally. The choice for the NICs therefore is not between retaining special and differential treatment or giving it up but whether they will negotiate their assumption of reciprocal obligations in the

new trade round or bilaterally. They are very likely to secure better terms in the GATT where they can coordinate their interests where appropriate with other developing countries and where commitments will be exposed to multilateral surveillance (and thus less subject to abuse than bilateral arrangements).

Conclusion

The opportunities for mutually beneficial bargains in the new round are numerous. But the NICs' historical attitudes toward the trading system and severe political constraints in the United States create an enormous reluctance to bargain. Who should take the initiative to break this deadlock?

A good part of the responsibility rests with the United States. To get negotiations in services and intellectual property, it should be ready to make firm standstill and rollback commitments to include not only European VCR restraints or Japanese agricultural quotas but also the long-term phasing out of textile, steel and other restrictions of primary interest to the NICs. Such an offer could smoke out the NIC hardliners and launch the new round in a hopeful spirit of concession and compromise. If necessary these commitments could be timebound and renewed each year or so, depending on mutual satisfaction of all parties with progress in the negotiations of special interest to them.

Once this level of bargain is struck, the way would be clear for reciprocal bargaining in all other areas. In each of these areas, whether it be a specific service sector or tariff negotiations or NTBs, special and differential treatment (SDT) for developing countries

might be preserved. Numerous possibilities arise:

- SDT might be more generous in service sectors than in traded goods and in high technology than in other manufactured goods, on the grounds that there is greater justification for infant industry protection at the upper end of the technology spectrum.
- Bargains in individual negotiations might reflect unequal substantive concessions by industrial and developing countries. This is the way developing countries have participated in previous GATT rounds. These bargains are made best in specific negotiating situations rather than on the basis of general principles.
- Substantively equal concessions in individual negotiations might be implemented differentially with developing countries being given more time to implement reduction of tariff or nontariff measures.
- Concessions by industrial countries might be implemented on a non-MFN or preferential basis with respect to developing country imports. This is the basis of GSP. Caution should be exercised here however. It is not at all clear that preferences have worked in favor of developing countries, certainly not the later industrializers. If the industrial countries eventually give up non-MFN action in the area of safeguards, the developing countries should think about doing so in the area of preferences.

The specific features of bargaining, however, are less the problem at this point than the strategic constraints on bargaining itself. The world community may have only a few more months to put bargaining back in the flexible and transparent arena of multilateral negotiations or see it devolve further into the secret and more constrained arenas of bilateral and regional deals.

END

10-86

DTIC