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# Multilateral Disciplines and the Question of Policy Space

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# 1 Introduction

“*What a strange town this is!*”
said Hoja Nasreddin to himself, as he tried to
break a stone from the frozen ground to chase
away the dogs barking and running towards him.
“*They tie up the stones and let the dogs go free*.”

AFTER a relatively short-lived win-win hype about globalization, there is now widespread concern among developing countries that their ability to control their economic and social development is increasingly circumscribed by their global economic integration. On the one hand, many of the policy instruments widely used by both mature and late-industrializers to reach their current levels of development are no longer available because of international rules and obligations and rapid liberalization and opening up. On the other hand, increased reliance on global markets is not generating broad-based improvements in living conditions. This concern has grown as the promises of free market reforms advocated by the Bretton Woods Institutions (BWIs) and the benefits claimed from the rules-based multilateral trading system have failed to materialize for large segments of the population in the developing world. This is a major reason why trade negotiations have been facing growing difficulties even though they are taking place at a time when the world economy is in its fifth consecutive year of strong growth.

Rapid integration into the global economic system diminishes national policy autonomy in two ways. First, liberalization of markets and dismantling of restrictions over cross-border movements of goods and services, and money and capital render economic performance highly susceptible to conditions abroad and weaken the impact of national policy instruments over macroeconomic and development policy objectives. Second, international rules and obligations diminish sovereign control over national policy instruments. These two sources of external constraints overlap and reinforce each other. On the one hand, liberalization of markets reduces the number of instruments controlled by policy makers much in the same way as sovereign policy autonomy is circumscribed by enhanced multilateral disciplines. On the other hand, multilateral rules and practices weaken the influence of national policy instruments over national policy objectives by promoting liberalization and opening up.

This paper focuses on multilateral disciplines in finance and trade. These include not only negotiated rules and obligations as contained in several World Trade Organization (WTO) agreements and the articles of agreement of the BWIs, but also conditionalities attached to lending by the latter. The following chapter will focus on the concept of national policy autonomy and the rationale for multilateral disciplines. This will be followed by a discussion of multilateral disciplines in finance and trade, and the question of coherence between the two. In finance, attention is on International Monetary Fund (IMF) surveillance over macroeconomic and exchange rate policies and loan conditionality. In trade, the rationale and nature of WTO rules and obligations and their effects on policy autonomy in developing countries are examined in four main areas: industrial tariffs, industrial subsidies, investment-related policies and technology-related policies. The need for reform in trade and finance is discussed with a view to bringing coherence and flexibility without undermining multilateral disciplines. Attention is also paid to the space that is available and the extent to which alternative policy instruments could be deployed in order to overcome the constraints entailed by multilateral rules and obligations.

The paper concludes with a discussion of the extent to which the existing policy space is used by developing countries and a summary of the main policy proposals.

There can be little doubt that in an interdependent world, there is a strong rationale for multilateral disciplines as a form of global collective action designed to prevent discriminatory and beggar-my-neighbour policies and to promote international economic stability. Current arrangements, however, suffer from a number of shortcomings. First of all, they lack coherence. While international trade is organized around a rules-based system with enforceable commitments, this is not the case in international money and finance. There are effectively no multilateral disciplines over macroeconomic and exchange rate policies of countries which have a disproportionately large impact on international monetary and financial conditions. This constitutes the single most important threat to the stability and openness of the trading system. It is also an important source of instability for the majority of developing countries which are highly vulnerable to external financial shocks.

The choice of which interactions should be brought under multilateral disciplines and the design of rules and practices are not neutral in the extent to which they accommodate the development trajectories of different countries. While industrial countries escape multilateral disciplines in money and finance, developing-country borrowers from the BWIs face conditionalities that circumscribe not only their macroeconomic policies but also broader development strategies. Existing multilateral rules and practices seek to promote free movement of industrial goods, capital and enterprises, which favours advanced countries, but not labour, agricultural products or technology, where benefits would be greater for developing countries. In legal terms the WTO rules and commitments provide a level playing field for all parties, but effective constraints they impose over national policies are much tighter for developing than for industrial countries.

These asymmetries are largely reflections of shortcomings in global economic governance. In principle, global collective action for multilateral disciplines should be a consultative process based on full, equal and voluntary participation. However, current multilateral processes do not meet these conditions. Many developing countries have little influence in the formulation of WTO rules or the conditionalities of the BWIs. Nor are they adequately represented in fora which set standards for harmonization of policies and practices. Furthermore, coercion is exerted by powerful countries in the formulation and implementation of rules and obligations. Thus, any reform of multilateral disciplines should start with governance issues.

However, multilaterally negotiated rules in trade and finance are not always the most important constraints over policy autonomy in developing countries, and they often leave more space than is sometimes portrayed. In several areas brought under the WTO legislation there is room for manoeuvre, notably in industrial tariffs, intellectual property rights and trade in services. On the other hand, many areas of policy remain outside existing multilateral legislation, including not only exchange rate and capital account regimes but also development-policy issues such as foreign direct investment (FDI), competition policy, and labour and environment standards. However, it should be added that there is now a mercantilist offensive by major industrial countries to tighten existing WTO rules and to subject many development-policy issues to WTO disciplines.

The space left by existing multilateral legislation has been lost in other ways. Many low-income countries dependent on aid have seen much of their policy space eroded by donor, IMF and World Bank conditionalities. There has also been widespread unilateral liberalization of trade, investment and capital account regimes. Several developing countries have undertaken commitments in bilateral or regional agreements with major industrial countries which typically extend WTO disciplines in tariffs, investment and intellectual property protection, and entail new obligations in areas left outside multilateral legislation such as capital account regimes, environment or labour standards.

It is notable that despite widespread acceptance of market-based, outward-oriented development strategies, and the proliferation of multilateral rules and obligations, there is still considerable diversity in national policy regimes in the developing world. The degree of harmonization of national policies and practices is limited, and the demise of the nation-state is wildly exaggerated. This diversity reflects not only the existence of room for different policies and practices, but also variations in the extent to which countries are willing or able to use the space available in order to align their policies to suit their own objectives and priorities, rather than to go along with the neoliberal model of development. This is particularly true in finance, as demonstrated by considerable diversity in capital account regimes. But there are also important inter-country variations in tariff, investment and technology policies within the rules and obligations established in the WTO. In general, governments in economies with deep-seated structural shortcomings, including a weak industrial base, low investment, large and persistent fiscal and current account imbalances, a high degree of dependence on foreign capital, a heavy burden of debt and persistent macroeconomic instability, tend to be more susceptible to loss of policy space and less willing to use the space available. This poses a dilemma since these countries would generally need to look beyond the mainstream policy advice in order to overcome the very structural shortcomings that make them highly susceptible to external pressures.

The central policy conclusion of this paper is that there is a need to reform the existing multilateral disciplines in order to bring greater coherence between trade and finance, and a better balance among countries in terms of the constraints they effectively face and the autonomy they enjoy. This should be an exercise of rationalization which could entail tighter, rather than looser, multilateral disciplines in some areas, notably in money and finance. It should aim at reconciling multilateral disciplines with policy flexibility. It is argued that this is best accomplished by incorporating flexibility into rules rather than providing policy space as exceptions. The paper makes specific proposals for achieving this in the four WTO-related policy areas examined.

The analysis also has implications for action at the national level. First, for some countries there may be both the need and scope to recover the policy space and flexibility lost through unilateral action. While policy reversal can be quite costly, this may be worth considering when potential benefits are large. Second and more importantly, in many countries there appears to be a need for a fundamental rethinking of development policy with a view to better using the space available and determining the additional space that needs to be gained in order to achieve national development objectives.

# 2 Issues at Stake

## Economic openness and policy autonomy

THE autonomy of national economic policy refers to the effectiveness of national policy instruments in reaching national policy objectives.[1] In conventional policy analysis it is generally assumed that national authorities have command over policy instruments, but not the ability to control specific national goals precisely in the way desired; that is, there is a gap between *de jure* sovereignty of national economic policy and *de facto* control over national economic development. Economic openness not only widens this gap by allowing foreign influences on national objectives, but also reduces *de jure* sovereignty of national economic policy by subjecting it to international disciplines and constraints.[2]

National authorities do not always have full command over policy instruments even in a closed economy insulated from external influences. Policy instruments are usually subject to boundary conditions (e.g., interest rates cannot be lowered below a minimum level); there are political and social limits to how far policy makers can go in using instruments such as taxes; and contractual obligations may limit discretionary policy action. Moreover,

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1 The distinction between instruments and targets constitutes the basis of the theory of economic policy first elucidated by Tinbergen (1952); see also Hansen (1967) and Bryant (1980: Chap. 2).

2 Examination of the impact of openness on policy autonomy goes back to Tinbergen (1956); see also Cooper (1968). For the distinction between *de facto* control over national development and *de jure* sovereignty of national economic policy, see Bryant (1980: Chaps. 10-12).

for a number of reasons formal command over policy instruments does not automatically translate into full control over development objectives. There may be trade-offs among various objectives sought (e.g., between full employment and price stability, or equity and efficiency) and it may not be possible to attain all of them simultaneously because of lack of an adequate number of effective instruments.[3] Again, as emphasized in the literature on rational expectations (Lucas 1976), private sector behaviour may not be independent of what policy makers intend to do so that a particular policy action can trigger offsetting behaviour.

More importantly, policy-making is a tentative process surrounded by uncertainties. Rational policy decisions need to rely on an implicit or an explicit model describing the structure of the economy, including the relations between instruments and objectives of policy. Not only is this structure unstable, but knowledge and information about it is highly imperfect. This problem is all the more serious when policy aims at structural change, which involves new variables, institutions and behaviour, rather than achieving certain objectives within a given structure, since effective implementation of structural policies would require a theory of institutional and structural change.[4] This means that specific instruments cannot always be assigned to predetermined objectives. Rather, a pragmatic approach would be needed, based on solving problems as they emerge in the achievement of the goals pursued. This calls for considerable flexibility in the policy-making process, including in the selection and application of instruments.[5]

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[3] As demonstrated by Tinbergen (1956) and Hansen (1967), formally it takes at least as many instruments to carry out a policy as there are linearly independent goals.

[4] The theory of economic policy originally developed by Tinbergen and others was not very much concerned with structural change, but took the basic economic structure as given.

[5] This seems to be the reasoning behind the argument by Rodrik (2004: 3) that "the analysis of industrial policy needs to focus not on policy *outcomes* – which are unknowable ex ante – but on getting the policy *process* right. We need to worry about how … private and public actors come together to solve problems in the productive sphere, … and not about whether the right tool for industrial policy is, say, directed credit or R&D subsidies."

While bringing certain benefits, economic openness aggravates policy dilemmas. In an open economy the need for flexibility is greater because policy objectives are influenced by volatile and unpredictable external factors including growth of and access to foreign markets, foreign interest rates and exchange rates, availability of external financing and debt servicing obligations. On the other hand, economic opening often has the implication of losing control over certain instruments. For instance, under an open capital account regime the exchange rate and the interest rate are both potential policy instruments, but at most only one of them can actually be employed as an independent policy instrument.[6] Briefly, with deepening integration into global markets, the range of policy instruments shrinks as, at the same time, foreign influences over national policy objectives become stronger and the trade-offs between internal and external objectives are intensified.

Economic openness and greater integration of countries into world markets is often accompanied by their insertion into international governance systems, coming under rules and procedures of multilateral institutions. The IMF has virtually become a universal organization with the collapse of communism while China's shift to capitalism and increased emphasis on international trade has culminated in its accession to the WTO. These rules and procedures narrow policy autonomy by reducing *de jure* sovereignty of national economic policy. It is often in this latter sense that policy space is used in its popular expressions; that is, it refers not so much to the implication of liberalization and openness for effectiveness of policy in attaining national objectives as to constraints placed on *de jure* sovereignty of national economic policy by international rules and obligations. However, liberalization can have similar consequences for policy autonomy as international obligations. For instance, there is little difference between loss of autonomy to use tariffs as an industrial policy tool because of WTO rules and loss of ability to use the exchange rate as an effective instrument

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6 For the distinction between potential and actual policy instruments, see Bryant (1980: Chap. 2).

for external adjustment because of capital account liberalization. In fact, these two sources of constraint over national economic policy are not always independent since multilateral rules and practices now generally push in the direction of faster liberalization and greater openness.

## The rationale for multilateral disciplines

A key question raised by shrinking policy space relates to the rationale for multilateral constraints over national policy autonomy. The answer lies in the provision of global public goods, including the minimization of global public "bads". Multilateral disciplines are a form of global collective action whereby governments voluntarily agree to reduce sovereignty on a reciprocal basis by subjecting their policies in specific areas to certain rules in the expectation that such an action would be mutually beneficial.[7]

Interdependence provides the principal rationale for multilateral disciplines because it gives rise to negative externalities and arbitrage opportunities. The environment is one area where adverse spillovers could be generated by policies and practices of a country beyond its borders. So is financial instability; financial crisis in a country can spread across several others through contagion, including to those with sound policies and good fundamentals. Lax financial standards or excessively liberal tax policies could give rise to regulatory arbitrage and migration of businesses at the expense of countries with more prudent regulations or progressive tax systems. In such cases the main objective of multilateral disciplines would be to prevent or control negative externalities linked to global public bads. But, multilateral cooperation and disciplines can also help maximize global public goods. Countries may be unwilling to undertake unilateral trade liberalization even when they believe that it would bring efficiency gains, for fear of its adverse repercussions for the balance of payments and

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[7] More precisely, such an action should be Pareto optimal; that is, it would improve the welfare of at least some of the countries involved without making any one of them worse off.

employment, but collectively they may be able to do so by securing greater reciprocal market access.

More importantly, interdependence creates opportunities for deliberate beggar-my-neighbour policies. A country can use its commercial, macroeconomic or exchange rate policies in order to create jobs and incomes for its citizens at the expense of others. This could, in turn, trigger retaliatory policy action by those affected, particularly when adverse external spillovers are large. In the absence of multilateral disciplines and cooperation, this process can easily run into fallacy of composition, creating instability and disruptions in international economic relations and leaving all countries worse off. In economics, provision of international economic stability as a global public good is now believed to be one of the most compelling reasons why multilateral disciplines are needed.[8]

To be a credible and legitimate form of global collective action, the process of multilateral rule-making should involve the voluntary and full participation of all the parties concerned. However, this is not always secured. Countries would naturally be inclined to shape multilateral rules and commitments so as to leave maximum policy space for themselves while restricting the space for others in areas which are crucial to their interests. This is where power play comes in. Since global distribution of power is asymmetric, the bargain struck is rarely equally beneficial to all the parties involved. The degree of coercion exerted by more powerful countries can go to such an extent that the resulting disciplines may in fact entail serious violation of sovereignty, leaving some of the parties worse off.

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[8] What exactly constitutes global public goods seems to be highly contentious (Kindleberger 1986). The increased significance of international externalities associated with growing interdependence among countries has resulted in the broadening of the concept of global public goods and greater public interest in their provision which often requires global collective action. Global security, international economic and financial stability, global environment, knowledge, humanitarian assistance and global health are now typically included among global public goods; see Kaul, Grunberg and Stern (1999); Phillips and Higgott (1999); Stiglitz (2002a); Bryant (2003); and Kaul, Conceição, Le Goulven and Mendoza (2003).

Such instances of violation of sovereignty are quite common in the history of commercial agreements, as exemplified by the gunboat diplomacy that pervaded the 19th century when exercise of political and military power by the United States and Britain shaped trade policies of independent but weak states such as China, Japan and the Ottoman Empire.[9] Recent years have also witnessed increased infringement of principles of participation and voluntarism in the formulation and implementation of multilateral rules in both the WTO and the IMF. In the WTO "green-room" practices or negotiations within exclusive clubs such as FIP (five interested parties) or G6 often leave out smaller and weaker stakeholders, and the United States legislative process plays a key role in determining the outcome of negotiations involving 149 countries. Similarly, initiatives for the harmonization of national financial policies in the IMF are often based on codes and standards set in fora where developing countries are barely represented. Intrusive conditionalities of the IMF have led to protestations even from conservative free marketers such as Feldstein (1998) on grounds that they interfere with the proper jurisdiction of sovereign governments.

In theory there is always the option for a country to stay out of or exit from multilateral arrangements and conduct its international business on a bilateral basis when excessive coercion is exercised in the formulation and/or implementation of the rules and commitments. However, such an option is constrained by the tyranny of financial markets and the threat of exit of transnational corporations. It is rarely exercised by small and weak countries also because coercion would be even more overwhelming in bilateral relationships with major economic and political powers. Thus the agreement reached during the eleventh session of the United Nations Conference on Trade and Development (UNCTAD XI) that "it is for each Government to evaluate the trade-off between the benefits of accepting international rules and commitments and the constraints posed by the loss of policy space" (UNCTAD 2004a: paragraph 8) has little practical

9 According to Krasner (1999), sovereignty of nation-states has always been violated throughout history.

significance for most developing countries. Consequently, as noted in the same declaration, it is all the more important for the international community to strike an "appropriate balance between national policy space and international disciplines and commitments" while "bearing in mind development goals and objectives."

Where the exact balance should lie between juridical sovereignty of nations, on the one hand, and multilateral disciplines and collective governance, on the other, is a highly contentious matter. There are certainly limits to multilateral disciplines when national borders are politically distinct. Just as the absence of any multilateral disciplines can disrupt international economic relations, proliferation of external constraints over national policies poses the risk of widespread and frequent repudiation of obligations, leading to conflicts and loss of credibility for the institutions overseeing them. This is particularly true when multilateral rules and obligations are established without voluntary and full participation.

How much countries would be willing to give up policy autonomy depends on the benefits they anticipate from greater economic integration. In general the degree of integration should be a matter for sovereign policy decision even though factors such as advances in communication and transportation technologies and geography play a role in determining *de facto* openness. This decision should seek to balance the costs and benefits of openness, including the cost of loss of policy autonomy. This implies a strategic approach to integration (UNCTAD TDR 1997) designed to seek an optimum degree of openness between the extremes of autarky and *laissez faire* (Bhaduri 2005). There now appears to be broad agreement that in this respect no single recipe suits all countries or applies across all spheres of economic activity such as trade, finance and investment. Moreover, the optimum degree of openness does not depend on narrow economic benefits and efficiency considerations alone. A number of other considerations, including equity and preservation of national culture and institutions, play a disproportionately greater role than is commonly appreciated in the mainstream approach to policy-making.

These imply that the policy space needed would be different for countries with different structural features and at different levels of development, and that equal disciplines or a level playing field around the same set of multilateral rules would mean different degrees of effective constraint over policy autonomy for different countries. In this respect, developing countries are confronted with a serious dilemma. While, on the one hand, they are unable to opt out of multilateral arrangements, on the other hand these arrangements are pushing for a one-size-fits-all deep integration which constrains the room for policies of strategic integration.

**Shifting objectives of multilateral disciplines**

The objectives of current multilateral disciplines are crucially different from those pursued by the planners of the postwar international economic architecture which helped produce the golden age in the industrial world and allowed considerable advances in developing countries. The postwar architecture was premised on the recognition that economic interdependence among nations called for a certain degree of international disciplines over policy-making, particularly with a view to reducing the scope for discriminatory and beggar-my-neighbour policies. But it also left considerable space for sovereign autonomy vis-à-vis markets. By contrast, current multilateral rules and practices seek to deepen economic integration through liberalization in areas of interest to industrial countries, and restrain policy autonomy by surrendering power to global markets dominated by transnational corporations (TNCs).

The design of the immediate postwar architecture was greatly influenced by the interwar experience when pursuit of self-interest by many countries through beggar-my-neighbour policies had led to the breakdown of international trade and payments. Faced with severe difficulties due to onerous debt burdens, volatile capital flows, financial instability, collapse of prices of many traded goods and strongly deflationary pressures, many countries had resorted to extensive and discriminatory restrictions on trade and payments, and used export subsidies, agricultural price support and competitive devaluations in an effort to defend incomes and employment of their citizens and to restore stability of their financial institutions. The outcome was a deep global economic crisis and progressive disintegration of the international economy.

It was thus agreed that the prevention of recurrence of such an outcome called for international cooperation in policy-making, including multilateral mechanisms designed to restrict discriminatory and beggar-my-neighbour policies in trade and finance. This was the rationale for the creation of the International Monetary Fund to ensure an orderly system of exchange rates and multilateral payments under conditions of strictly limited international capital flows, and for the proposal to establish a rules-based framework for international trade on the core principle of non-discrimination. These arrangements were based on broad agreement on three issues. First, markets could not always be relied on to generate economically efficient and politically acceptable outcomes. Second, close linkages among trade, finance and development imply that solutions should not be sought in isolation. Finally, because of cross-border dimensions and global spillovers, these policy issues cannot be left to uncoordinated individual country actions. These principles allowed considerable room for policy intervention while securing international disciplines and a reasonable degree of coherence among multilateral rules and obligations in trade and finance.[10]

While the current approach to the organization of the international economic system is driven by a desire to achieve a deep and broad global economic integration compared to the shallow integration sought by postwar planners (Ostry 2000), the ongoing liberalization-cum-integration process does not cut across all sectors but is highly selective. Deep integration is pursued in three areas where advanced countries have the upper hand: free movement of industrial products, money and capital, and enterprises. By contrast, the lid is kept on three areas where liberalization would generally benefit

[10] On how these principles shaped the postwar international economic architecture, see Akyüz (2004 and 2006a). For the historical evolution of the multilateral economic system, see UNCTAD TDR (1984: Part II).

the developing world: namely, agricultural goods, labour mobility and technology transfer. Social considerations are invoked for leaving labour and agriculture out, and protection of property rights and incentives for innovation are used as justification for restrictions over free flow of technology. This selective approach to liberalization has the consequence that existing multilateral rules and practices exert greater constraints on the ability of developing countries to move forward in their development trajectory than that of advanced countries.

At the intellectual level this process of integration is supported by arguments in favour of the virtues of free markets vis-à-vis the tribulations of government intervention, notwithstanding the exceptions made in the areas noted above. According to this view, encapsulated in the Washington Consensus, government intervention is generally harmful because it distorts allocation of resources, promotes inefficiency and corruption, and inhibits growth and development. Even when there are market failures due to factors such as externalities, public goods, imperfect and asymmetric information, imperfect competition and incomplete markets, there may be little justification for policy intervention since the consequences of government failure are much more serious than those of market failures. Thus, it is argued, external constraints over policy through conditionalities of the BWIs or the WTO rules and obligations serve a useful purpose in preventing government failures and promoting sound policies and increased reliance on market forces, particularly in developing countries where there are serious problems of governance. According to globalization fundamentalists, economic integration and multilateral disciplines are in fact placing governments in a "Golden Straightjacket" as "the defining political-economic garment" since the only answer to a higher standard of living is now the free market.[11] Often this "Golden Straightjacket" is also invoked by ruling elites in many developing countries for dismantling government intervention and unleashing market forces.

11 See Friedman (1999: 86). For a critique of the "Golden Straightjacket" view of the world, see Bryant (2003: 124-128) and Mosley (2005).

For liberal orthodoxy the principal rationale of the WTO is not to provide a framework for an orderly, non-discriminatory, rules-based system of international trade in recognition of diversity in national strategies for openness and the balance between private and public action, but to promote rapid liberalization. The unconditional most-favoured-nation (MFN) principle that governed the postwar arrangements has increasingly been replaced by market access and national treatment as liberalization and "non-distortion" have become the organizing principles of international trade and investment. In fact, the drive to seek greater liberalization of markets than would be feasible at the multilateral level has eroded the MFN principle by giving rise to proliferation of bilateral and regional free trade and investment agreements.

Liberalization has also become the central concept in the operations of multilateral financial institutions. Prevention of policy distortions and government failure through conditionalities attached to lending to developing countries has come to be considered as the principal rationale for the continued existence of the World Bank even though international capital markets could assume the task of provision of external financing to many developing countries.[12] Again the IMF is seen as a useful instrument for disciplining governments in developing countries even though it has no effective power to exert multilateral disciplines over exchange rate and macroeconomic policies of countries that matter most for international economic and financial stability.

Whatever the merits of the arguments about respective roles of governments and markets in economic matters, they cannot provide a legitimate basis for organizing the international economic order. To the extent that countries are

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12 This has been argued even by economists who are otherwise critical of orthodoxy: "it is more plausible to locate the Bank's comparative advantage in assisting developing countries in the presence of weaknesses and distortions in member countries' domestic political processes than in overcoming the international capital market imperfections" (Gavin and Rodrik 1995: 311). See also Rodrik (1995) and Gilbert, Powell and Vines (1999). For a discussion of the rationale for multilateral financial institutions, see Akyüz (2006a).

responsible for their own destiny, they have the right to choose or experiment with any system of organization of their economic affairs provided that it does not amount to discriminatory and beggar-my-neighbour policies or create large negative spillovers beyond their borders. Arguing for policy space is not arguing for a particular stance in industrial, trade and technology policies, but denying it amounts to one-size-fits-all prescriptions fashioned on the requirements of the development trajectories of industrially advanced countries.

In any case there is considerable doubt about the credibility of orthodox arguments. Neither economic theory nor historical evidence provides a strong causal link between openness and economic development. While trade, technology and industrial policies have not always been used effectively, there is barely any example of successful industrialization without government support and protection in these areas. However, the orthodoxy constantly downplays the role of successful industry policy interventions in East Asia.[13] It also disregards that many of the trade, technology and industrial policy instruments now denied to developing countries were successfully employed by today's developed countries during their industrial transformation.[14] As documented in the literature on the economic history of Western Europe and its offshoots, protectionism was the rule, free trade the exception during the industrialization of today's mature economies. While industrial leaders often favoured free trade, followers used all kinds

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[13] The orthodox explanation of the East Asian experience has gone through phases. Originally, there was a tendency to ignore selective industrial policy interventions and portray it as a market-based experiment. Subsequently, such interventions had to be recognized but were dismissed on grounds that they did not matter or that the conditions that allowed them to make a contribution to industrialization do not exist in other countries. For a recent critical assessment of these propositions, see Wade (2003b).

[14] This neglect is particularly notable in view of the existence of a vast body of literature on the history of trade, investment, technology and financial policies in mature and late-industrializers. For an overall assessment, see Chang (2002). On trade barriers, see Bairoch (1993), O'Rourke and Williamson (2000), Hufbauer (1983), UNCTAD TDR (1984) and Akyüz (2005a); on investment policies, see Chang (2003) and Kumar (2005); and on technology policies and patent rights, see Bercovitz (1990), Gerster (2001), Chang (2001) and Kumar (2003).

of policy tools to support and protect their infant industries in order to catch up with the more advanced economies. Most of these countries severely regulated foreign investment when it was in their own interest. Domestic financial systems often developed under capital controls and restrictions over entry and discriminatory treatment of foreign institutions. Selective and specific subsidies were extensively used to support emerging industries. Patent rights were introduced only at a late stage of development, and protection accorded to foreigners was exceptionally weak in order to allow nationals easy access to advanced technology. Denying such policy options to developing countries is aptly described as another instance of *kicking away the ladder* to prevent the followers from closing the income gap with more advanced countries (Chang 2002).

# 3 Multilateral Constraints Over Policy Autonomy

## Asymmetry and incoherence between trade and finance

THE existing system of global economic governance lacks effective multilateral disciplines over exchange rate, macroeconomic and financial policies, or for redress and dispute settlement regarding the negative impulses generated by such policies. In this respect governance in money and finance lags behind that for international trade. It is particularly notable that while recent years have seen considerable tightening of international disciplines in trade and several other areas of policy addressed in the WTO, there has been no attempt to fill the vacuum created by the breakdown of the Bretton Woods arrangements despite increased international monetary and financial instability and recurrent crises in emerging markets. In a way, finance has become the vanguard of an international liberal order, premised on the assumption that financial markets can do their own disciplining and do not need international rules.

That exchange rate disciplines and stability are a prerequisite for open and expanding trade was clearly recognized by the architects of the Bretton Woods system. This was most lucidly expressed by Keynes (1980: 5):

> "… there is a logical reason for dealing with the monetary proposals first. It is extraordinarily difficult to frame any proposals about tariffs if countries are free to alter the value of their currencies without agreement at short notice. Tariffs and currency depreciations are in many cases alternatives. Without currency

> agreements you have no firm ground on which to discuss tariffs... It is very difficult while you have monetary chaos to have order of any kind in other directions."

The importance of coherence among different components of the international economic system was also put in broader terms in paragraph 4 of the Marrakech Declaration:

> "Ministers recognize, however, that difficulties the origins of which lie outside the trade field cannot be redressed through measures taken in the trade field alone. This underscores the importance of efforts to improve other elements of global economic policymaking to complement the effective implementation of the results achieved in the Uruguay Round."

When currencies can move rapidly in relatively short periods from one level to another, multilateral disciplines over tariffs would not provide a predictable trading environment since such swings easily alter relative competitive positions. It takes several years of negotiation to achieve 10 to 20 per cent tariff cuts, but under floating and free capital mobility exchange rates of major currencies are known to have fluctuated as much over a matter of a couple of weeks. On the other hand, when exchange rates remain divorced for prolonged periods from economic fundamentals, arguments advanced in favour of free trade lose their rationale. In fact, even on mainstream reasoning, there would be a strong justification for tariffs and non-tariff protection to correct distortions caused in trade flows and resource allocation by exchange rate misalignments.

Adverse impulses for trade are also generated by unpredictable and large swings in interest rates on major reserve currencies that dominate international transactions. Hikes in interest rates raise debt servicing obligations of countries whose external debt is contracted in reserve currencies and tighten the balance-of-payments constraint. They can also redirect capital flows away from deficit and indebted countries, aggravating external financial difficulties. Often, these necessitate restrictions over imports through cuts in economic activity or introduction of tariff and non-tariff barriers, leading to contraction in world trade.

The burden of adverse monetary and financial impulses invariably falls on the trading system because of the implicit acceptance by the international community of the priority of meeting financial obligations over observance of commitments to free trade. This is spelled out in Article XII of the General Agreement on Tariffs and Trade (GATT) which provides that "any contracting party, in order to safeguard its external financial position and its balance of payments, may restrict the quantity or value of merchandise permitted to be imported" subject to certain provisions.[15] There are, however, no analogous provisions in the international financial system allowing countries facing serious payments difficulties to suspend their financial obligations. The asymmetry between trade and finance in bearing the brunt of balance-of-payments disequilibria continues unabated as recent attempts to introduce orderly debt workout procedures including temporary debt standstills have been blocked by international financial markets and the United States government (Akyüz 2002 and 2005b).

Lack of multilateral disciplines in money and finance is a major concern to developing countries because they are highly vulnerable to external financial shocks and such shocks are more damaging than trade shocks. Boom-bust cycles in capital flows to developing countries and major international financial crises are typically connected to large shifts in macroeconomic and financial conditions in the major industrial countries. The sharp rise in the United States interest rates and the appreciation of the dollar was a main factor in the debt crisis of the 1980s. Likewise, the boom-bust cycle of capital flows in the 1990s which devastated many countries in Latin America and

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[15] It should, however, be noted that in practice this provision is rarely applied. India failed to invoke it after the IMF expressed the view that its reserves were adequate − see Raghavan (1999). In reality the burden still falls on trade as countries facing severe balance-of-payments difficulties are obliged to implement austerity measures, cutting economic growth and imports.

East Asia was strongly influenced by shifts in monetary conditions in the United States and the exchange rates among the major reserve currencies (UNCTAD TDR 1998: Chap. IV; and 2003: Chap. II). Even though it has been increasingly recognized that the global economy will not achieve greater stability without some reform of the G3 (i.e., dollar, euro and yen) exchange rate regime, and that emerging markets remain vulnerable to currency crisis as long as reserve currencies are highly unstable, the exchange rate system and the governance of international capital flows have hardly figured on the agenda for the reform of the international economic architecture. Despite lack of multilateral disciplines in money and finance, and the continued monetary instability, trade liberalization has been pushed forward as if a consistent monetary order existed, resulting in frictions in the trading system.

## International monetary and financial disciplines

### *a. What disciplines?*

The Bretton Woods system was designed to close two main channels of exchange rate instability. First, it sought to limit the scope for markets to generate unexpected and erratic movements in exchange rates through restrictions over short-term arbitrage flows which had proved so damaging in the interwar period. Second, it restricted the ability of governments to manipulate exchange rates of their currencies by subjecting them to multilateral disciplines. However, it also provided considerable space for national policy when underlying conditions called for exchange rate adjustment. Thus, countries undertook obligations to maintain their exchange rates within a narrow range of their agreed par values, but they were allowed to change their par values under fundamental disequilibrium. An unauthorized change in par value would enable the IMF to withhold the member's access to its resources and even to force the member to withdraw (Dam 1982: 90-93).

The demise of the Bretton Woods system changed all that. While floating was adopted with the understanding that its stability depended upon orderly underlying conditions, obligations regarding exchange rate arrangements under Article IV of the IMF's Articles of Agreement failed to strike a balance between national policy autonomy and multilateral disciplines. Indeed, as pointed out by Triffin (1976: 47-48), they were "so general and obvious as to appear rather superfluous", and the system "essentially proposed to legalize … the widespread and illegal repudiation of Bretton Woods commitments, without putting any other binding commitments in their place."

With exchange rate obligations effectively gone, the only multilateral disciplines left in monetary and financial matters concern current account convertibility and currency practices. According to Article VIII of the Fund, members are obliged to avoid restrictions on current payments and discriminatory currency practices.[16] They are required to obtain the approval of the Fund to impose restrictions on the making of payments and transfers for current account transactions. Members failing to comply with these obligations can become ineligible to use the general resources of the Fund. These obligations are subject to the provisions of the scarce currency clause of Article VII which permit countries to impose exchange controls on current transactions against a currency declared to be scarce, and the provisions of transitional arrangements under Article XIV which allow a country to maintain the restrictions on payments and transfers for current international transactions that were in effect on the date it became a member. The scarce currency clause, which was originally designed with the United States in mind and which could help put pressure on surplus countries, has never been implemented while transitional arrangements have been rapidly dismantled with widespread adoption of current account convertibility by developing countries.[17]

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16 It is notable that originally multiple exchange rate practices differentiating between current and capital transactions were not considered as a violation of obligations regarding current account convertibility in Articles VII and XIV (Dam 1982: 133).

17 In 1970 only 34 countries out of a total of 115 members of the Fund had accepted current account convertibility. This figure increased to 143 out of 186 in 1997 (Dailami 2000: Table 15.2).

The Articles of the Fund do not provide a global regime for cross-border capital transactions with clearly defined rights and obligations of recipient and source countries, and international debtors and creditors. Although they allow the Fund to request members to exercise control on capital outflows, this provision has never been invoked even at times of rapid exit of capital and financial meltdown in emerging markets during recent years. Nor do the Articles provide protection against creditor litigation against countries imposing unilateral standstills at such times even though the IMF Executive Board recognized that such an action might be needed (Akyüz 2005b: 10-11 and 16-17). While the Articles recognize the right of members to regulate international capital flows, in reality the Fund has encouraged liberalization of the capital account. In effect, as pointed out in a recent report by the IMF Independent Evaluation Office, the Fund lacks not only clear and effective jurisdiction over capital account issues but also a "clear position" (IMF/IEO 2005a: 11 and 50).

### *b. Surveillance*

There has been an attempt to balance the lack of specific obligations with respect to exchange rate policies with increased emphasis on surveillance over national policies in the context of Article IV consultations. With the second amendment of its Articles, the Fund was charged with exercising firm surveillance over members' policies, at the same time as members were allowed the right to choose their own exchange rate arrangements. Initially surveillance focussed primarily on the sustainability of exchange rates and external payments positions, and on monetary and fiscal policies as their principal determinants. The guidelines established in 1977 made an explicit reference to the obligations of members to avoid manipulating exchange rates to gain an unfair competitive advantage over other members.[18] The scope and coverage of surveillance have expanded over time into structural policies, the financial sector and capital flows, particularly after a series

[18] See Executive Board Decision no. 5392-(77/63) adopted on 29 April 1977.

of emerging market crises (IMF/GIE 1999). Various codes and standards established for macroeconomic policy, institutional and market structure, and financial regulation and supervision have thus become important components of the surveillance process (Cornford 2002: 31-33).

The increased coverage of surveillance has not been accompanied by measures to make it more symmetrical and balanced between developed and developing countries. First of all, financial codes and standards are determined in fora where developing countries either are unrepresented, such as the Financial Stability Forum; have limited representation, such as the Bank for International Settlements and Basle Committee; or have limited power, such as the IMF itself where the concentration of voting rights in the hands of major industrial countries allows them to have a determining influence and veto power over key decisions. The obligations contained in the new codes and standards reflect the view that the main causes of financial instability and crises are to be found in the policies and institutions of emerging markets, but entail neither a fundamental change in policies and practices in the source countries nor improvement in the transparency and regulation of currently unregulated cross-border financial operations. Indeed, as they are established on the basis of best practices or benchmarks appropriate to major industrial countries, their implementation would require little change in policies and practices in industrial countries while necessitating fundamental reforms in developing countries. Despite the emphasis on voluntary participation, the implementation of such codes and standards is backed by an extensive system of externally applied incentives and sanctions (Cornford 2002: 63-72). As one observer pointed out, this "new set of external disciplines come hand-in-hand with a particular model of economic development of doubtful worth" (Rodrik 1999: 3).

More importantly, the Fund is unable to exert meaningful disciplines over the policies of its non-borrowing members and prevent unsustainable exchange rates and balance-of-payments positions, and currency manipulations.[19] This is true not only for developed-country creditors of the Fund, but also for non-borrowing developing countries. For its borrowers the policy advice given by the IMF in Article IV consultations often provides the framework for conditions to be attached to any future Fund programme (IMF/GIE 1999: 20). But its surveillance of the policies of the most important players in the world economy has lost any real meaning with the breakdown of the Bretton Woods system, the establishment of universal convertibility of the currencies of major industrial countries, and the emergence of international financial markets as a main source of liquidity. Even though, as stipulated in Article IV, all countries have the same *de jure* obligation "to assure orderly exchange rate arrangements and to promote a stable system of exchange rates", the Fund's policy oversight is confined primarily to its poorest members who need to draw on its resources because of their lack of access to private finance and, occasionally, to emerging markets experiencing interruptions in their access to private financial markets.

It is notable that exchange rate policies have become an important source of conflict among major economies. In view of its growing trade deficit with China, the United States has been arguing that China has been deliberately keeping its currency undervalued by pegging it to the dollar and intervening in currency markets to absorb excess supply of dollars. The United States Congress has been urged to pass a bill to impose tariffs on imported Chinese products in order to protect its manufacturing sector. However, such an action could not be justified by invoking GATT provisions. This would require, *inter alia*, determination by the IMF that the Chinese currency is manipulated. However, according to the Fund's Articles of Agreement, fixing a currency against a foreign currency is not illegitimate nor does it constitute exchange rate manipulation, leading to legal counsel that "any settlement of the dispute over China's exchange rate for the Yuan is more

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19 The Fund has also been unable to prevent build-up of financial fragility and crises in emerging market economies under its supervision. However, this is not because it did not have leverage over policies in these countries, but because of shortcomings in its diagnosis of the underlying problems and recommendations; see Akyüz (2005b).

likely to come from diplomacy than from legal challenge" (Denters 2003: 2).

### c. *Conditionality*

The original rationale of conditionality was to protect the financial integrity of the Fund and the revolving nature of its resources. This called not only for relatively short repayment periods but also for macroeconomic adjustment in borrowing countries to bring external imbalances to sustainable levels.[20] However, subsequently conditionality has become one of the most contentious issues as the balance between financing and adjustment was gradually lost. Rather than providing adequate liquidity to weather payments difficulties, the Fund started to impose exactly the kind of policies that the postwar planners wanted to avoid in countries facing payments difficulties – that is, adjustment through austerity – irrespective of whether these difficulties were due to excessive domestic spending, distortions in the price structure, or external disturbances such as terms-of-trade shocks, hikes in international interest rates or trade measures introduced by another country.

More importantly, the Fund has become increasingly involved in broader development issues and moved rapidly towards structural conditions, including those related to governance. Consequently there has been a proliferation of structural performance criteria and governance-related conditionalities in the past two decades, covering a wide area of policy, ranging from trade and finance to public enterprises and privatization, and even labour market institutions and social safety nets (Goldstein 2000; Kapur and Webb 2000; and Buira 2003). The average number of structural conditions doubled between the 1970s and 1980s, and at the end of the 1990s it was more than 50 for a typical Extended Fund Facility programme

[20] For the original rationale and the subsequent evolution of IMF conditionality, see Dell (1981). See also Polak (1991), Jungito (1994), Kapur (1997), Mohammed (1997), Goldstein (2000), Kapur and Webb (2000), Buira (2003), Babb and Buira (2005) and IMF/IEO (2005b). Much of what is discussed here also applies to conditionality by multilateral development banks, notably the World Bank.

and between 9 and 15 for standby programmes. The number of structural performance criteria in the IMF programmes with the three Asian countries hit by the 1997 crisis was four times the average for all Fund programmes over 1993-1999, leading to concerns that there was a "temptation to use currency crises as an opportunity to force fundamental structural and institutional reforms on countries" (Feldstein 1998). The World Bank was not spared from such temptations. On a strict definition of conditionality used by Kapur and Webb (2000: 5-7), the number of conditions attached to lending at the end of the 1990s by the Fund and the Bank together ranged between 15 and 30 for sub-Saharan Africa (SSA) and 9 and 43 for other regions. These numbers go up to 74-165 for SSA and 65-130 for other regions if a looser definition is adopted.

Questions have been raised by several researchers, both inside and outside the BWIs, about the effectiveness of conditionality in preventing policy failure and improving economic performance (Stiglitz 2002b; Gilbert, Powell and Vines 1999; Ocampo 2001; Meltzer Commission 2000; and Kapur and Webb 2000). By leaving too little room to domestic policy makers, it naturally leads to slippages. Indeed, evidence shows that with the proliferation of structural conditions in the 1980s and 1990s, the degree of compliance declined. According to Mussa and Savastano (1999), less than half of Fund-supported programmes met the test of compliance during 1973-1997. The decline was particularly dramatic in the 1990s: during 1993-1997 only 27.6 per cent of the 141 arrangements could be considered to be in compliance. A study reviewing the evidence concluded that "obtaining compliance with Fund conditionality has been a serious problem, including the Fund's structural conditionality. The compliance problem has been getting more serious over time."[21]

More importantly, there is very little correlation between compliance and economic performance, and often much of the improvements in performance

[21] Goldstein (2000: 47). See also Buira (2003: 8-9).

could be attributed to the increased funding that accompanies programmes. For instance, in 1993 the World Bank identified 15 countries in sub-Saharan Africa as a core group of adjusters on the basis of their compliance with the policies recommended, including significant institutional changes. However, subsequently only three of these countries were among what the Fund called "strong performers". In other words, the large majority of countries that accounted for much of the faster growth in SSA in the second half of the 1990s were not among the high-compliers five years earlier, while most of the countries that were thought to be pursuing sound policies at the time were not among the subsequent strong performers (UNCTAD TDR 1998: 124-125 and Table 34). More generally, while evidence lends support to the conclusion that Fund programmes have positive effects on the balance of payments, this is not true for their effects on growth and income distribution (Goldstein 2000: 63).

The Fund's extensive use of structural conditions in its lending programmes is widely considered a violation of the guidelines established in 1979, which explicitly state that performance criteria would normally be confined to macroeconomic variables, and that they could relate to other variables only in exceptional cases when their macroeconomic impact is significant. As argued by a former Research Director of the IMF, these guidelines aimed at making conditionality "less intrusive by limiting the number of performance criteria, insisting on their macroeconomic character, circumscribing the cases for reviews, and keeping preconditions to a minimum. Yet, these restraining provisions have not prevented the intensification of conditionality in every direction that the guidelines attempted to block."[22]

There is a strong rationale for well-designed macroeconomic conditionality not only as a device for risk management by the IMF as a lender (Kapur and Webb 2000: 1-2), but also for securing orderly international payments,

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[22] Polak (1991: 53-54). In response to mounting criticism, the Fund management issued new guidelines in 2002 (IMF 2005). However, they do not address the fundamental problem of intrusiveness of structural conditionality, an issue now evaluated by the Independent Evaluation Office; see IMF/IEO (2005b).

notwithstanding the uneven treatment in this respect of borrowing and non-borrowing members. Structural conditions, however, by their nature, are different. They impose a particular model of development, entail permanent changes in institutions, and circumscribe policies in such ways that their reversal may be extremely difficult. By doing so they can create asymmetry between programme and non-programme countries, and even change the balance of power between them in international economic relations. For instance, there was a clear attempt to use the Fund support during the Asian crisis to pursue the interests of its major shareholder. Another case in point is trade liberalization, which has increasingly become an essential component of IMF surveillance and conditionality, in part as a result of pressure from the United States as part of conditions for its agreement to quota increases.[23] Unilateral trade liberalization undertaken by developing countries with Fund programmes puts them at a disadvantage in multilateral trade negotiations. A country liberalizing unilaterally acquires no automatic rights in the WTO, but it could become liable if it needs to take measures in the context of Fund programmes in breach of its obligations in the WTO.[24]

### d. *Reform of the Bretton Woods Institutions*

Any reform of the BWIs should start with questions of mandate and governance in order to define clearly their role in the multilateral economic architecture, rather than the terms and conditions of their lending.[25] There is a strong case for the Fund to go back to its original mandate and focus on safeguarding international monetary and financial stability, leaving national

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[23] IMF/GIE (1999: 61). The World Bank also used conditionality for import liberalization until the completion of the Uruguay Round, but passed the buck to the Fund afterwards and focussed on market access and liberalization in industrial countries, notably in agriculture; see World Bank (2006).

[24] For a discussion of this issue, see WTO (2004a). In Korea financial restructuring undertaken with the support of the Fund after the 1997 crisis naturally resulted in an increase in government equity in financial institutions. This became a basis for a legal challenge in the WTO on grounds that such measures constituted actionable subsidies; see WTO (2003: paragraphs 8-10).

[25] For an elaboration of the proposals discussed in this section, see Akyüz (2005b).

structural-cum-development issues to the World Bank. Its involvement in the latter issues is an unjustified diversion and duplication. All facilities created for this purpose could be transferred to the Bank as the Fund terminates its activities in development policy and long-term lending. It could then focus on its core responsibility of preventing exchange rate misalignments and gyrations, persistent global trade imbalances and crises in emerging markets.

With its exit from development finance, the Fund's lending activities would be confined, as originally envisaged, to the provision of short-term liquidity to countries facing temporary payments difficulties. The key reform issue here is how to strike a balance between financing, on the one hand, and macroeconomic and exchange rate adjustment, on the other, and how to design performance criteria without going into micromanagement in monetary and fiscal matters. Greater automaticity in the access to the Fund's resources would certainly be helpful in both respects.

The Fund should not be allowed to bail out lenders and investors in countries facing financial crises since such operations create creditors' moral hazard and shift the burden onto debtors. Instead, it should help develop orderly workout mechanisms to prevent financial meltdown and to restructure debt which cannot be serviced according to its original terms and conditions. Temporary debt standstills and restrictions on capital flows should thus become legitimate ingredients of multilateral financial arrangements. These would not only bring a better balance between debtors and creditors and limit the abuse of the Fund's power over countries facing financial crisis, but also prevent the burden of external financial difficulties from being placed on the trading system.

The Fund cannot succeed in fulfilling its core responsibility without effective power vis-à-vis non-programme countries. In this respect there is no quick fix, but some scope for improvement in several areas. Consideration should be given to reviving the scarce currency clause to combat mercantilist tendencies and to deter constant reliance on exports rather than expansion of domestic demand. Special Drawing Rights could replace the quota system and existing borrowing arrangements to eliminate reliance of the IMF on major industrial countries for funding. Separating surveillance from lending decisions and assigning it to an authority independent of the IMF Executive Board could improve its quality, legitimacy and impact. Finally, any reform designed to bring greater authority and legitimacy would also need to address shortcomings in the Fund's governance in several areas including the selection of its head, the distribution of voting rights, transparency and accountability.

While transfer of development issues to the Bank would strike a better division of labour between the BWIs and address the problems associated with IMF structural conditionality, the role of the Bank would also need to be redefined in order to avoid migration of the problems from one institution to another. Since the Bank does not have a mandate to impose multilateral disciplines over national policies, any conditionality attached to its lending should be limited to securing its financial integrity. Again this problem could best be addressed if the Bank went back to its original operational modalities and concentrated on facilitating capital investment through project financing alone, rather than trying to fix all kinds of policy and institutional shortcomings in developing countries through structural adjustment and development policy loans.

Delinking bilateral and multilateral arrangements for development finance should be an important step in broadening the policy space of countries borrowing from multilateral organizations. Certainly, it is up to sovereign nations to enter into bilateral agreements on debt and financing, but these should be kept outside the multilateral system. This means taking the donor-driven facilities out of the BWIs; that is, the International Development Association (IDA) from the World Bank and the Poverty Reduction and Growth Facility (PRGF) from the IMF. Thus, the Bank should cease to be an aid institution and become a development bank again, intermediating between international financial markets and developing countries. As originally envisaged, its financing should be provided in loans rather than grants, and made available only to countries which do not have access to private capital on reasonable terms.

Such arrangements would still leave the problem of financing global public goods including concessional loans and grants to the poorest countries. Here the issue is twofold: institutional arrangements and resources. Aid could be pooled and allocated through a development fund placed under the United Nations, run by a competent secretariat without day-to-day interference from its contributors, reporting to the General Assembly and audited regularly by an independent body. Such an arrangement would be desirable not only because of increased involvement of the UN in development goals and social issues closely linked to world peace, but also because of its democratic nature.

Poverty reduction has been declared as a global public good in several UN summits and conferences in recent years. This carries a strong rationale for establishing global sources of development finance. This could be achieved through agreements on international taxes, including a currency transactions tax (the so-called Tobin tax), environmental taxes and various other taxes such as those on arms trade, to be applied by all parties to the agreement on the transactions and activities concerned and pooled in the UN development fund.[26] A common feature of these is that they are all sin taxes which would provide revenues while discouraging certain global public bads such as currency speculation, environmental damage or armed conflict and violence. While universal participation is highly desirable, such agreements do not always necessitate the participation of all countries. Certain sources of revenue, such as the Tobin tax, would need to be introduced globally in order to avoid arbitrage against countries adopting them, but others, including environment taxes, could be introduced on a regional or plurilateral basis.

An advantage of such arrangements over present aid mechanisms is that once an agreement is reached, a certain degree of automaticity is introduced

[26] See Atkinson (2005) for such sources of development finance.

into the provision of development finance without going through politically charged and arduous negotiations for aid replenishments and national budgetary processes often driven by narrow interests. Such a fund could also be supplemented by voluntary contributions from governments, both in the North and the South, private foundations and wealthy individuals. Even existing IDA resources could become part of the endowment provided that the donors agree to hand them over to an independent secretariat.

## WTO rules and obligations

### *a. Core principles, rules and exceptions*

Unlike multilateral arrangements in money and finance, the GATT-WTO trade regime is organized around binding and enforceable rules and commitments established on the principles of non-discrimination and reciprocity. These rules and commitments apply to a host of agreements which are not all about trade, including the GATT, the General Agreement on Trade in Services (GATS), and the agreements on Trade-Related Aspects of Intellectual Property Rights (TRIPS), Trade-Related Investment Measures (TRIMs), and Subsidies and Countervailing Measures (SCM).[27]

The core principle of non-discrimination has two basic components. First, the most-favoured-nation (MFN) rule which requires that the "like products" of all members be treated in the same way, with the benchmark being the best treatment offered to any country, whether or not it is a member. This rule in effect prohibits granting more favourable treatment to certain countries and requires extension of tariff concessions to all members. The second component of non-discrimination is national treatment, which provides a level playing field between foreign and domestic goods in domestic markets: that is, after entering a member country, foreign goods should enjoy treatment not less favourable than that applied to domestic products.

[27] For a lucid analysis of the framework for international trade, see Das (1999).

This rule is designed to ensure that within-border treatment of foreign goods does not diminish or remove the concessions accorded to them under the MFN rule by differential application of domestic measures such as taxes. In the same vein, as in TRIMs, it also prohibits regulations favouring utilization of domestic products over foreign products. With the establishment of the WTO, there has been a tendency to extend the application of the national treatment principle from trade in goods to non-trade areas of TRIPS and GATS. There have also been proposals by developed countries to extend it further to investment and competition policy.

Unlike orthodox rhetoric that unilateral trade liberalization is always welfare-enhancing for the country undertaking it, the GATT-WTO framework is essentially based on the recognition that trade concessions could lead to costs and they need to be reciprocated so that there are benefits to all.[28] However, parties do not usually expect to derive net benefits from each and every agreement taken separately, but from the package as a whole − something that provides the rationale for cross-bargaining and "the single undertaking". For instance, during the Uruguay Round (UR) many developing countries agreed to GATS, TRIPS and TRIMs despite the understanding that they could face costs and incur losses, because of the expectation that they would obtain additional market access in industrial countries in agricultural products and textiles and clothing. Nevertheless, it is notable that every single agreement, including TRIPS, has been portrayed by liberal orthodoxy as beneficial to developing countries.[29]

There are basically two sets of exceptions to these rules and principles: those that apply to all parties, and special and differential treatment accorded to certain members. In the former respect, the most important exception is the

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[28] It has also been argued that reciprocity helps to mobilize gaining sectors and segments in support of trade liberalization, thereby balancing the opposition of losers; see Finger and Winters (2002).

[29] On exchanging market access for TRIPS, see Finger (2002). This is also recognized by the World Bank (2002: 129), which nevertheless argues that there are long-term benefits of TRIPS to developing countries.

so-called escape clause which allows a member to suspend its obligations under certain conditions in order to safeguard its industry against import surges. Safeguards are designed as temporary emergency measures, to be accompanied by adjustment, not as instruments of protection to establish competitive firms and industries. There are also exceptions to the MFN rule. Perhaps the most important ones are the provisions which allow free-trade agreements and customs unions among members, and the exemptions granted to specific commitments under GATS. Government procurement and certain types of subsidies are also exempted from the national treatment rule.

Second, there are exceptions granted to developing countries. These go back to the so-called enabling clause introduced in 1979 under "Differential and More Favourable Treatment, Reciprocity and Fuller Participation of Developing Countries." It provides exceptions to the MFN rule by allowing developing countries to enjoy preferential market access and to offer limited or less-than-full reciprocity. This clause, in principle, implies recognition of the infant-industry argument. However, in practice, special and differential treatment has generally been confined to longer transition periods − but not long enough to allow infant industries to mature and become viable in competition with early starters from advanced industrial countries. In addition, Part IV of the GATT 1994 includes a "best endeavour"-type provision for differential treatment.

Another important exception for developing countries is provided by the 1994 balance-of-payments provisions of Article XVIIIB of the GATT which allow them to deviate from their obligations on a temporary basis and use import restrictions, including quantitative barriers, in order to safeguard their external financial positions and foreign exchange reserves. Again this constitutes a recognition of vulnerability of developing countries to occasional balance-of-payments difficulties and their limited access to international financial markets. Article XVIIIA permits modifications or withdrawal of concessions in order to support the establishment of a particular industry and Article XVIIIC permits import restrictions for similar purposes, but such provisions are rarely used because they call for compensatory concessions to other countries adversely affected (Das 1999: 100-101).

The constellation of these rules and exceptions constitutes a complex legalistic structure that lends support to different interpretations and practices which occasionally lead to disputes. These are extensively discussed in the literature. The following section will examine their economic significance for developing countries in four key areas: industrial tariffs, industrial subsidies, investment-related policies and technology-related policies. Given that a level playing field defined legally can have totally different economic consequences for different countries according to their levels of development, attention will be paid to the extent to which *legally equally binding constraints* also provide *economically equally biting constraints* over policies in different countries, notably between developed and developing countries. The ultimate purpose is to determine the nature of constraints over policy autonomy in developing countries and the space that is still available. Where these rules and commitments are found to be incompatible with development trajectories of these countries, proposals are made for their reform, based on the recognition that any flexibility introduced into the rules should be compatible with multilateral disciplines.

### ***b. Key restrictions over policy space***

#### *1. Industrial tariffs*

Until recently WTO disciplines for industrial tariffs were not considered as a major source of constraint over commercial policy in developing countries. This is in large part because the modalities adopted in the UR had provided substantial flexibility to these countries in setting their industrial tariffs. During the UR negotiations agreement was reached for reduction in average tariffs (by 30 per cent by developing countries and 40 per cent by developed countries), but freedom was left for the choice of product lines to be bound and the extent of tariff reduction to be made in each product line. There was no wholesale liberalization that applied to all tariff lines. Even though there was a proposal for harmonizing tariffs across all product lines through what came to be known as the non-linear Swiss formula approach designed to bring deeper cuts to higher tariffs, this was not agreed even by some industrial countries, most notably the United States, which still had high tariffs for certain product lines (Khor and Goh 2004: 8-9).

This flexibility has resulted in considerable diversity among countries regarding their binding coverage for industrial tariffs. While most developed countries have almost full binding coverage, in the developing world this is the case only for some countries, notably in Latin America. The average binding coverage for developing countries is now 77.5 per cent, and for least developed countries (LDCs) 44 per cent (Fernandez de Cordoba and Vanzetti 2005: 7). Even though bound tariff rates are high in many developing countries, applied rates are much lower because of trade liberalization undertaken voluntarily or as a result of conditionalities imposed by the BWIs. Simple average applied tariffs in developing countries in 2001 stood at around 11 per cent compared to an average bound rate of some 29 per cent. The corresponding numbers for developed countries were lower, at 4.7 and 5.7 per cent respectively. However, much of the tariff peaks in developed countries are in products of export interest to developing countries (Fernandez de Cordoba, Laird and Vanzetti 2004b).

This diversity and freedom enjoyed by developing countries in choosing which tariff lines to bind and where to bind them can disappear in the negotiations of the Doha work programme on non-agricultural market access (NAMA).[30] The framework for modalities for negotiations for NAMA, as contained in Annex B of the so-called July Package (WTO 2004b), and the Hong Kong Ministerial Declaration, and based primarily on the proposals made by developed countries, stipulates binding almost all industrial tariff lines and reducing bound tariffs on a line-by-line basis according to a non-linear Swiss formula. The main objective is to harmonize tariffs

30 Much of the remainder of this section draws on Akyüz (2005a).

across both products and countries. In effect, such a procedure would, for many developing countries, translate unilateral liberalization into WTO commitments. In some cases the application of the Swiss formula could bring the newly-bound rates below the current applied rates, forcing the latter to be lowered even further.

The proposed cuts would imply a drastic narrowing of bound tariffs between developed and developing countries. On some proposals, the difference between simple average bound tariffs of these countries could fall from its current level of some 23 percentage points to as little as 5 percentage points (Fernandez de Cordoba, Laird and Vanzetti 2004b: Table 5a). Again, there would be a considerable compression of tariff differences among developing countries. For instance, a sharp cut according to the Swiss formula would reduce the dispersion of industrial tariffs among developing countries, excluding LDCs, as measured by standard deviation of average bound tariffs, from more than 20 percentage points to less than 3 percentage points. Even a more moderate application of the non-linear formula would reduce the intra-developing-country dispersion of bound tariffs to 6 percentage points.[31]

Since the proposed tariff cuts would be applied on a line-by-line basis, the result would be a considerable decline in tariff dispersion across products. The application of a non-linear formula could reduce the dispersion of tariffs among industrial products, as measured by standard deviation of average weighted bound tariffs, by more than two-thirds.[32] This would no doubt bring a large reduction in tariff peaks in developed countries in products of export interest to developing countries. However, the move towards uniform tariffs would be much more rapid in developing countries where tariff dispersion is wider. This would also mean reduced ability of these

31 For bound tariffs of individual developing countries before and after the application of various formulas, see Fernandez de Cordoba, Laird and Vanzetti (2004b: Appendix Table A1).

32 These estimates are based on Fernandez de Cordoba, Laird and Vanzetti (2004b: Table 8).

countries to differentiate between imports of basic necessities and luxury consumables; among intermediate, capital and final goods; and between high- and low-value-added manufactures in their treatment of tariffs.

All these could generate adverse consequences for developing countries on several fronts. First, to the extent that the negotiations result in deep cuts in applied tariffs, their impact on the balance of payments, employment and income could well be negative since the evidence generally shows that rapid liberalization tends to raise imports much faster than exports, particularly in low-income countries.[33] Second, they would also lead to sharp declines in government revenues from trade taxes in poorer countries where such taxes account for an important part of the budget. Since it is unlikely that tariff cuts would bring a rapid increase in imports in these countries because of balance-of-payments constraints, and value-added taxes could rarely make up for lost trade taxes, the decline in government revenues could be particularly large.[34]

The immediate adverse effects of increasing binding coverage and lowering bound tariffs on the balance of payments, income and employment, and trade taxes could be expected to be moderate for those developing countries where applied tariffs are already at very low levels. By contrast, their longer-term implications for industrialization and development could be more serious. An irreversible commitment to low tariffs across a whole range of sectors would carry the risk of locking developing countries into the prevailing international division of labour since many of them would need to provide support and protection to new sectors needed for industrial

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33 See Santos-Paulino and Thirlwall (2004), UNCTAD (2004b) and Kraev (2005). In the conventional analysis of the impact of trade liberalization, based on computable general equilibrium (CGE) models, resource utilization and trade balances are assumed to be unchanged. These CGE models almost invariably find efficiency gains from liberalization. For a critique, see Akyüz (2005a).

34 Fernandez de Cordoba, Laird and Vanzetti (2004a) and South Centre (2004). These concerns are justified since evidence shows that many low-income developing countries dependent on trade taxes have been unable to recover the revenues lost from trade liberalization; see Baunsgaard and Keen (2005).

upgrading. The loss of freedom to use tariffs for industrial development carries even greater risk today because many of the more effective and first-best policy options successfully used in the past for industrial upgrading by today's mature and newly-industrialized countries are no longer available to developing countries because of their multilateral commitments in the WTO, notably in the agreements on subsidies, TRIMs and TRIPS.

The proposals, in effect, remove the flexibility provided during the Uruguay Round to developing countries for their industrial progress. It is generally true that for any given industry, protection and support provided should be lowered and phased out over time as it matures and becomes competitive. However, since industries do not emerge spontaneously, tariffs may need to be raised for new, more advanced industries (e.g., high-tech products) as they emerge sequentially in the process of industrial upgrading, while being phased out for less advanced industries (labour-intensive and low-tech products) as they gain competitiveness. Thus, at any point in time, effective use of tariffs for industrialization would require the coexistence of very low and very high tariffs; that is, dispersion across tariff lines can be very wide.[35] Over time tariff dispersion is expected to increase initially as the economy moves towards more demanding industries, but decrease subsequently with industrial maturity. Similarly, average tariffs would rise in the intermediate stages of industrialization as the economy diversifies away from resource-based and labour-intensive manufactures, and then start falling with industrial maturity. Finally, since countries at different stages of industrial development can coexist, there would be little harmonization across countries. In particular, countries at the intermediate stages of industrialization would need higher average tariffs than both mature industrial countries and those at the early stages of industrialization. While mature industrial countries are expected to dismantle tariffs over time, LDCs would need to move towards higher tariffs as they enter technology-intensive industries.

[35] The mainstream literature sees tariff dispersion as a welfare-reducing distortion. But even in a static context, there is not always welfare (Pareto) justification for uniform tariffs, or the so-called concertina rule advocated by the BWIs; see Neary (1998).

Thus, in the process of sequential build-up of competitive industries under temporary infant-industry protection, the optimal level and structure of tariffs would change over time. Consequently, focussing on the needs of existing industries or taking current levels of applied tariffs as the basis for commitments in the WTO could present serious setbacks to subsequent technological upgrading. A country at an earlier stage of industrialization might be applying very low tariffs for high-tech products because it has not yet entered into such sectors, aiming, instead, at retaining high tariffs for labour-intensive and low-tech manufactures in order to protect its existing industries. But emphasizing short-term benefits to the neglect of long-term industrial development could lock it into the current pattern of industrial specialization, making it difficult to move up on the technology ladder. Similarly an LDC can remain dependent on primary production and exports if it is denied the space to support labour-intensive manufactures.

A main argument advanced in favour of binding tariffs and reducing the margin between bound and applied rates is that these would bring greater predictability to trade policy and increase security of market access and the stability of the international trading system (see, e.g., Francois and Martin 2002). There can be little doubt that this argument has certain merits. Indeed, in this respect developing countries already moved very rapidly in the course of the Uruguay Round when they raised the binding coverage from about 22 per cent to over 75 per cent of total tariff lines over a matter of a decade, while developed countries came close to full binding coverage only after half a century of trade negotiations.

It should, however, be kept in mind that greater binding coverage would provide increased predictability of market access only as long as countries are able to cope with its consequences. If they are forced to undertake commitments which cannot be fulfilled without serious disruptions, they would be inclined to resort to other, less transparent means of import restrictions, thereby creating trade frictions and weakening multilateral disciplines. On the other hand, it is unlikely that the discretion allowed for infant-industry protection would give rise to unpredictable changes in tariffs, but gradual adjustments as sectors are established and mature. In this respect, exchange rate instability constitutes a more serious threat to the predictability and stability of the international trading system. Thus, if major developed countries really want to reduce uncertainty in international trade, they should turn their attention to establishing a more stable international monetary system.

The key issue here is how to reconcile multilateral disciplines with policy flexibility needed for industrial progress in developing countries. Setting bound tariffs line-by-line at sufficiently high levels so as to accommodate all contingencies would provide considerable flexibility, but it would also render multilateral commitments superfluous. In any case, as noted, developing countries do not need high tariffs for all sectors and all the time. But they should have the option of using tariffs on a selective basis as and when needed for progress in industrialization. They should not be expected to keep moving tariffs downward from one trade round to another, but be able to move them in both directions for different sectors in the course of industrial development.

This kind of flexibility is best accommodated by binding average tariffs without line-by-line commitment; that is, to leave tariffs for individual products unbound, subject to an overall constraint that the average applied tariff should not exceed the average bound tariff. Clearly, the average bound tariff should be high enough to accommodate the needs of different sectors at different stages of industrial maturity. Such an approach does not only have the advantage of simplicity, but it would also reconcile multilateral disciplines with policy flexibility since countries would be subject to an overall average ceiling in setting tariffs for individual products. Furthermore, for most countries in the early and intermediate stages of industrial development, it would result in lower average tariffs than would be the case under line-by-line commitments. In practice it would have the effect of balancing tariff increases with reductions; a country would need to lower its applied tariffs on certain products in order to be able to raise them elsewhere. This would encourage governments to view tariffs as temporary instruments, and to make an effort to ensure that they effectively serve the purpose they are designed for; that is, to provide breathing space for infant industries before they mature and catch up with those in more advanced economies.

### 2. *Industrial subsidies*

The agreement on SCM provides one of the most comprehensive sets of disciplines in the WTO. It constitutes a major departure from the pre-WTO GATT regime which lacked comprehensive principles and rules on subsidies and allowed considerable freedom to developing countries in the use of support measures for export promotion and import substitution.[36] The agreement deals with this issue at three levels: it provides rules and restrictions regarding governments' use of subsidies; determines the type of action that could be taken against violating members; and specifies the procedures to be followed.[37] The main objective of the agreement is to prevent the so-called trade-distorting, targeted direct or indirect government support to firms and industries. Restrictions are imposed not only on export subsidies but also on those provided for domestic sales in accordance with the national treatment principle. The agreement applies mainly to industrial subsidies. GATS contains no subsidy disciplines for services while special rules apply to agriculture. For services, the disciplines on subsidies are under negotiation.

The concept of subsidy is defined to include transfers by governments and public agencies, and intra-private-sector transfers affected through government intervention. Budgetary transfers could take the form of direct payments, foregone revenues and rights, government guarantees and equity participation, and provision of goods and services by public agencies below

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[36] In fact, the Subsidies Code that emerged from the Tokyo Round recognized that subsidies were an integral part of development programmes. I am grateful to B. L. Das for this information.

[37] For a detailed description, see Das (1999: Chap. 4.1) and Ayala and Gallagher (2005).

their market value. Benefits conferred by differential application of certain rules to different sectors and activities are also considered as subsidies even if they involve only intra-private-sector transfers without any financial repercussions for public agencies. This would for instance be the case in directed bank credits to certain sectors at preferential rates set by the government where the cost of implicit subsidy would be borne by non-preferential private borrowers.

The SCM agreement classifies subsidies into three categories according to whether they are trade-distorting and causing injury to other members: permissible (green light), prohibited (red light) and actionable (amber light) subsidies. Subsidies that are not specific to firms and industries are permissible or non-actionable while specific subsidies are either prohibited or permissible but actionable.[38] This corresponds to the distinction between "functional" and "selective" intervention which has occupied a central place in the debate on the role of the government. Provision of various public goods and services to all domestic enterprises in the form of subsidized physical and social infrastructure or cheap energy supplies resulting from low energy taxes would not be in violation of the rules set by the SCM agreement. The agreement allows even selective subsidies provided that the subset of activities and enterprises earmarked are not confined to export and import-competing firms and industries. Thus, it should be possible to apply differential tax rules or public service charges to enterprises according to their size.

Specific subsidies in three areas are defined as non-actionable: for research and development, disadvantaged regions and environmental purposes. Although these were introduced for a period of five years, to be phased out at the end of 1999, it was agreed during the 2000 review not to challenge the

[38] Actionable subsidies are not prohibited. However, they are subject to challenge, either through multilateral dispute settlement or through countervailing action, if they cause adverse effects to the interests of another member.

continued use of such subsidies, making them only potentially actionable, until the issue is reviewed and agreement is reached on the use of subsidies for development purposes.

Direct and indirect assistance to firms and industries contingent on export performance is explicitly prohibited. This is also true for import-substitution subsidies – that is, assistance promoting the use of domestically produced, as opposed to imported, products. However, subsidies to domestic producers competing with imports are not among the prohibited but actionable subsidies – a grey area between prohibited and permissible subsidies. These are permitted but actionable if they inflict costs on other members by causing or threatening material injury, violating the national treatment principle through the impairment of trade concessions, and prejudicing their interests. LDCs and countries with a per capita income of less than $1,000 (Annex VII developing countries) are permitted to use export subsidies until graduation from this category. Developing countries as a whole benefit from higher thresholds in the application of countervailing duties.

In assessing the extent to which the agreement on SCM limits policy space, it should be noted that the distinction between economywide and sector-specific subsidies is not always clear-cut in their incidence. A subsidy to a specific sector (e.g., energy and education) could have significant economywide implications when it has strong linkages. Similarly, economywide subsidies can benefit only a limited number of industries, as in assistance to prevent industrial pollution. Since in practice it may be difficult to determine whether a subsidy is, in fact, specific (Anderson 2002: 168), there is scope to design subsidies in such a way that they can help import-competing and export sectors without contravening WTO rules and triggering retaliatory action. In reality many industrial countries seem to be able to provide considerable support to industry through carefully crafted and disguised subsidies (Weiss 2006).

According to some authors, while prohibition of subsidies terminates a powerful development tool, the liberal “bark of the WTO appears to be worse than its bite", allowing newcomers sufficient policy space to exploit, particularly in view of its emphasis on science and technology.[39] It is also noted that the rules impose few constraints on those countries seeking to subsidize development of a fledgling industry that may not yet be export-oriented or subject to significant import competition (Weiss 2006: 6). This can be particularly important for small firms which usually begin by supplying local markets.

However, a careful reading of the agreement shows that many instruments of support effectively used by late-industrializers are now outlawed and could trigger retaliatory action, particular in view of pervasive mercantilist tendencies. These constraints are particularly biting for middle-income countries seeking industrial upgrading. The instruments that were formerly used extensively but are now outlawed include subsidies in the form of direct payments, tax credits and tax holidays for import-competing and export sectors; generous tax rebates and duty drawbacks for exporters; selective allocation of licences for technology imports and investment; preferential access to credit at subsidized interest rates for export financing and investment; and provision of subsidized infrastructure services.[40]

The rationale for prohibition of selective subsidies is the same as that for the harmonization of tariffs across product lines; namely, to minimize distortions in international trade and resource allocation. However, this rationale has not been taken to its logical conclusion. According to the mainstream theory, avoiding distortions in the allocation of resources requires neutral incentives between imports and exports. Free trade meets this condition. But when there are tariffs on imports, neutral incentives would obtain only if the effective rate of protection for importables is equal to the effective

39 Amsden (2000: 6) also argues that "new WTO rules give ample opportunities for countries to promote their manufacturing sector. Whatever else WTO laws are designed to do, they may be construed as being in favour of advancing science and technology." See also Amsden and Hikino (2000).

40 For measures used by the Asian newly-industrialized economies (NIEs), see Weiss (2005a), Pangestu (2002) and English and de Wulf (2002).

rate of subsidy for exportables; that is, the elimination of anti-trade bias introduced by tariffs calls for export subsidies (Bhagwati 1988). Many orthodox economists indeed explain the East Asian success not by selective intervention through tariffs or subsidies per se, but by neutrality of trade incentives.[41] The negotiations on NAMA recognize a role for industrial tariffs despite the push for harmonization and cuts. This implies that, on orthodox thinking, the prohibition of export subsidies contains a bias against trade.

More importantly, the agreement on SCM does not have a consistent rationale for permissible and prohibited subsidies. The rationale for permitting specific subsidies for R&D, environment and regional development is said to be correction of market failures.[42] But these are not the only areas where markets fail. The literature is replete with examples of capital market failures and externalities which necessitate infant-industry support to firms and industries to enable them to undertake certain activities with high social rates of return which they would not otherwise be willing or able to do. When capital markets are reluctant, because of asymmetric information, to finance learning and cover initial losses of potentially efficient and profitable firms, targeted credit allocation could be an effective and perhaps the only way for upgrading into new activities. Such failures are certainly more common in developing countries. They have also become pervasive in recent years as financial liberalization has led to greater instability and encouraged taking a short-term view in lending decisions. These provide a strong rationale not only for infant-industry intervention in the allocation of investment credits but also for directed and subsidized export credits and credit insurance.

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41 For a discussion, see Weiss (2005a: 16). This was also claimed to be the case in the *East Asian Miracle* study of the World Bank (1993: 298) which noted that despite tariffs and subsidies, domestic prices in Asian NIEs were closer to international prices than in other developing regions.

42 Drawing on Hoekman and Kostecki (2001), Ayala and Gallagher (2005: 7) argue that the crafters of the agreement differentiated between subsidies justified on market failure grounds and those that are not.

Again, when a firm is unable to fully internalize the benefits of its activities, it would be reluctant to undertake them unless it is subsidized to meet part of the costs it incurs in return for the social benefits it generates. This would be the case when, for instance, it provides training to workers but is unable to retain them to reap the benefits of improvements in their skills. Similarly, part of the benefits of services and information generated by first movers into export industries are reaped by followers and this would deter expansion of exports into new areas unless leading firms are subsidized. Under such conditions support measures including matching grants could help promote exports (English and de Wulf 2002: 162).

In all these cases subsidies serve to align social and private costs and benefits, and have the same rationale as supporting environment-friendly technologies or R&D activities where social return is much higher than private return. Thus, prohibiting certain types of infant-industry subsidies while allowing others with similar economic rationale is a major inconsistency in the agreement on SCM.

There is also the much-debated inconsistency between agricultural and industrial subsidies. Current WTO rules allow both export subsidies and domestic support to agriculture while severely restricting them in industry. This asymmetry clearly works against developing countries. Indeed, the role of subsidies is embedded within a broader issue concerning the relative significance of different sectors, and intersectoral transfer of resources between agriculture and industry at different stages of development. In most developing countries at the early stages of industrialization, the scope for making transfer of resources to agriculture through direct and indirect subsidies is highly limited. This is not just a matter of fiscal constraints, but availability of general resources outside agriculture to effect such transfers.

Consequently, while industrial countries provide massive subsidies to agriculture, this sector is generally taxed in developing countries through pricing policies and export taxes in order to mobilize resources for industrialization. In some parts of the world, marketing boards established during the colonial period have been used for this purpose. In Africa in the 1970s, for instance, agricultural exports contributed between 20 and 40 per cent to government revenue. Agriculture was taxed at similar rates in other parts of the developing world, including Asia, except that in the latter region an important part of the resources thus mobilized went back to agriculture as infrastructural investment, helping to raise productivity. Although since the early 1990s marketing boards have generally been dismantled, export taxes eliminated and many developing countries have moved towards more liberal agricultural pricing policies with the support of the BWIs, these steps only removed anti-agricultural bias rather than resulting in the kind of assistance provided by industrial countries.[43]

Developing countries appear to be ambivalent about the policy constraints brought by WTO disciplines regarding industrial subsidies because, unlike richer countries, they often lack financial resources to provide extensive support to emerging and/or declining industries. Given that many of them already suffer from massive agricultural subsidies provided in the developed countries, they do not seem to be willing to open up this route for industrial products as well. While the constraints brought by the agreement on SCM could be particularly biting for middle-income countries which need to move rapidly towards dynamic, high-value-added industries, the exceptions granted to Annex VII countries provide them more space than they can possibly exploit given their financial constraints.

The subsidy regimes that middle-income countries need are not independent of commitments they are obliged to make with respect to industrial tariffs. Indeed, a judicious combination of tariffs and subsidies characterizes the industrial take-off in many successful late-industrializers. The policy mix was based on the recognition of the need to combine market discipline with

[43] For a discussion of taxation of agriculture, see UNCTAD TDR (1998: Part 2, Chaps. 2-3) and Anderson (2002); and for a review of agricultural support in developed and developing countries, see Aksoy (2005) and Baffes and de Gorter (2005).

government support and protection, and of the importance of competing in international markets. Tariffs were used in order to allow emerging industries to earn additional profits (rents) in domestic markets to cross-subsidize exports while government subsidies were linked to performance indicators which included, among others, export performance. The space for generating intra-firm subsidies through protection of domestic markets is now narrowed significantly not only because of liberalization of industrial tariffs, but also due to anti-dumping provisions. Under these conditions, cost-reducing subsidies would gain additional importance, particularly for finance, energy, imported capital and intermediate goods, and infrastructure services.

There is a strong rationale for multilateral disciplines over the use of subsidies in traded goods sectors. However, it should also be recognized that the prohibition of industrial subsidies places much greater constraint over industrial development in countries at early and intermediate stages of industrialization than in mature industrial countries. As in industrial tariffs, here too multilateral disciplines could be reconciled with flexibility by setting aggregate limits to subsidies that developing countries could use while allowing flexibility in their allocation among different firms and industries. This would be similar to the provisions on Aggregate Measurement of Support (AMS) for agriculture where targets for percentage reduction were set at the aggregate level while leaving considerable flexibility to countries in the allocation of reductions among different products (Das 1999: 242; UNDP 2003: 118-119). Aggregate limits could be set as a proportion of GDP rather than industrial output, in order to provide greater space to countries at early stages of industrialization.

These limits could also be supplemented by the kind of provisions currently applied to Annex VII countries in the use of export subsidies. These stipulate that a country cannot continue to subsidize an industry once it has become competitive, and competitiveness is presumed to have been achieved once a country's exports of a product reach 3.25 per cent of world trade in that product. However, it might be preferable to use revealed comparative advantage (RCA) indices instead of arbitrary thresholds. Thus, a developing country could be allowed to use export subsidy for a product as long as the share of that product in its total exports is less than the share of that product in world trade. The same could be applied to import-substitution subsidies; that is, a developing country could subsidize producers and users of import-competing products so long as the share of that product in its imports exceeds the share of that product in world trade.[44]

Aggregate limits on industrial subsidies, compounded by subsidy-eligibility criteria for individual products or industries based on some measure of competitiveness, would be superior to the alternative of extending to all developing countries the exemptions made for Annex VII countries. As in industrial tariffs, an overall limit would generate competition in the use of subsidies among different sectors. Countries would be discouraged from using subsidies to support declining industries since this would impede industrial upgrading.

As for industrial countries, they are the main beneficiaries of the general exceptions allowed for subsidies for R&D, environment and regional development. In particular, R&D subsidies meet the needs of most of these countries to support innovation and technological progress. Maintaining these exceptions would thus strike a balance between developed and developing countries.[45] There is no rationale for allowing developed countries to use other types of industrial subsidies.

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[44] This measure should apply to both finished goods and components. In the latter case a high level of imports relative to world trade would indicate competitiveness in assembly operations but dependence on foreign-produced components. Thus, subsidization would help increase the domestic content of assembly production. For a discussion of RCA for exports and imports and its application to the Chinese situation on the eve of its accession to the WTO, see UNCTAD TDR (2003: 158-162).

[45] There are also other good reasons for retaining these exceptions – see Ayala and Gallagher (2005).

### 3. *Investment-related policies*

There are two main sources of WTO disciplines on investment-related policies: the agreement on TRIMs and specific commitments made in the context of GATS negotiations for commercial presence of foreign enterprises, or the so-called mode 3, in the services sectors. In addition to these, a number of other agreements provide disciplines, directly or indirectly, on investment-related policies, such as the prohibition of investment subsidies linked to export performance in the agreement on SCM. There was also an attempt by OECD countries to broaden WTO disciplines on foreign direct investment (FDI) policies in recipient countries by means of a multilateral agreement on investment (MAI), but this has been dropped from the agenda for the time being as a result of resistance by developing countries. However, there is now a renewed effort by some industrial countries to bring investment policies in developing countries under tighter multilateral disciplines through a fundamental change in the modalities of services negotiations in the Doha Round.

The TRIMs agreement does not refer to foreign investment as such but to investment generally. Following a subsequent interpretation by a panel on a TRIMs dispute, its provisions are now understood to apply to domestic investment as well as FDI.[46] The agreement is simply a reiteration of GATT provisions for national treatment and quantitative restrictions in the context of investment measures, but has nothing to say about market access or national treatment of foreign investors. It effectively prohibits attaching conditions to investment in violation of the national treatment principle or the restrictions regarding the utilization of quantitative measures. From an economic point of view, the most important provisions of the agreement relate to prohibition of domestic-content requirements whereby an investor is compelled or provided an incentive to use domestically produced rather than imported products, and of foreign-trade or foreign-exchange-balancing

[46] For a detailed treatment of the TRIMs agreement, see Das (1999: Chap. 3.6) and Bora (2002).

requirements linking imports by an investor to its export earnings or to foreign exchange inflows attributable to investment.

Even though these provisions apply to domestic and foreign investment alike, the debate on the extent to which they constrain policy space in developing countries has almost invariably focussed on FDI.[47] This is in part because the arrangements in the WTO in this respect are highly unbalanced. First of all, there are no multilateral disciplines restricting beggar-my-neighbour investment policies by recipient countries through various incentives to foreign firms, including for investment in export industries linked to international production networks. Such incentives provide effective subsidy to foreign investors and can influence investment and trade flows as much as domestic-content requirements or export subsidies, particularly since a growing proportion of world trade is taking place among firms linked through international production networks controlled by TNCs.[48] More importantly, multilateral restrictions through TRIMs over policies in recipient countries vis-à-vis TNCs are not matched by multilateral codes of conduct for TNCs, which are known to practise trade-restricting policies (Kumar 2005: 194). These create asymmetry not only between TNCs and recipient governments, but also between developed and developing countries. Since most developing countries do not have TNCs investing abroad to any significant extent, the benefits accruing to countries from the agreement on TRIMs are not reciprocal in so far as restrictions imposed over government policies in recipient countries serve to boost the profits of investors.

According to mainstream thinking, performance requirements are both

47 See, e.g., Wade (2003a), Kumar (2005) and Weiss (2006).

48 There is a body of literature which argues against multilateral disciplines for incentives on grounds that if they are ineffective there are no real negative spillovers, and if they are effective they improve global allocation of FDI; see Hoekman and Saggi (1999: 12-13). Not all mainstream economists agree that FDI incentives are non-distorting — see, e.g., Bhagwati (1998). That incentives tend to distort investment patterns in much the same way as export subsidies distort trade patterns, see Kumar (2002).

ineffective and harmful. While it is recognized that restrictions on FDI have a rationale because they operate under imperfect competition (see, e.g., Rodrik 1987), it is nevertheless maintained that competition policies are superior. Similarly, it is argued that import restrictions could justify export performance requirements, but it would be better to liberalize trade. More generally, on this view, policy failures in other areas do not provide a valid rationale for restrictions on FDI since the best course of action should be to remove such failures. Accordingly, multilateral disciplines on FDI are often seen as a way of preventing such failures. All these contentions are supported with some empirical evidence on the ineffectiveness of local-content and related policies.[49]

These sweeping generalizations do not stand up to closer scrutiny. First of all, competition policies in developing countries are not always effective in restraining abuse of monopoly power by TNCs. Furthermore, an environment of maximum competition is not the best way to nourish national firms in developing countries. It is now firmly established that restrictions over and management of competition among national firms contributed to industrial success in Japan and Korea.[50] More importantly, it has long been established, both theoretically and empirically, that the benefits of FDI in terms of transfer of technology, managerial and organizational skills are not automatic, but greatly influenced by policy. This is why many governments in both developing and developed countries have used performance requirements, and indeed continue to do so, taking advantage of exemptions and loopholes in multilateral, bilateral and regional agreements. Both cross-country and case studies show that in several instances performance requirements made a positive contribution to various development objectives, and that if designed appropriately, they can make a considerable difference to the quality of investment without having a major adverse impact on its quantity.[51]

49 For a statement of the neoliberal position, see Hoekman and Saggi (1999 and 2002). The empirical evidence in question comes from Moran (1998).

50 On the role and limits of competition, see Amsden and Singh (1994) and Singh (2002).

51 On theoretical issues involved and empirical evidence, see a number of essays in Kozul-Wright and Rowthorn (1998), Kumar (2005) and Rasiah (2005).

Clearly the impact of the provisions of the TRIMs agreement depends very much on the objectives pursued in attracting FDI as well as the nature of investment. While most financially-constrained countries, notably in Latin America and Africa, seek FDI for its potential contribution to the balance of payments and government finances, others, particularly in Asia, emphasize its role in the transfer of technology and entrepreneurial know-how, and in the linkages with international production networks and global markets for goods and finance. A large proportion of FDI in Africa is in the exploitation of minerals; in Latin America in the form of acquisition of government assets, including non-traded public utilities; and in East Asia in labour-intensive assembly industries linked to international production networks (Akyüz 2006b).

The effect of TRIMs can be expected to be limited in countries receiving FDI mainly for the exploitation of mineral resources. Such investment is generally capital-intensive and countries which depend on foreign know-how and experience in extractive industries often lack capital good industries. Linkages with domestic industries are usually weak and output is almost fully exported. Thus, restrictions on domestic content and foreign-exchange-balancing requirements would not have a significant impact on policy space. Here a main issue could be pre-export processing to increase domestic value added. It is possible to use export taxes to discourage exports of unprocessed minerals. These considerations also apply to agricultural commodities where export taxes could be equally effective in encouraging domestic processing. However, it should be noted that this space could be lost if recent proposals in the WTO by Japan and the European Union for restricting export taxes are adopted.[52]

[52] See Goh (2006). It is particularly notable that Japan in its proposals stresses the restrictions over export taxes for mineral resources.

Where FDI is in non-traded services, including public utilities, the question of domestic content can come up mainly in relation to follow-up investments by foreign companies acquiring domestic assets. Since countries relying on FDI for privatization often face structural payments difficulties and since the contribution of FDI in non-traded goods and services to the balance of payments is generally negative over the long term, restrictions over domestic-content requirements could aggravate external imbalances.

The TRIMs provisions are particularly biting for investment in manufacturing for domestic and/or international markets, notably in automotive and electronics industries. Perhaps the single most important restriction here concerns domestic-content requirements. In developing countries, most of the industries linked to international production networks have high import contents in technology-intensive parts and components while their domestic value added often consists of wages paid to unskilled or semi-skilled workers.[53] Raising domestic content of such production is important not so much because of its impact on the balance of payments as because development of domestic industries for technology-intensive parts and components constitutes an important step in industrial upgrading.[54] Restrictions over domestic-content requirements would thus limit transfer of technology and import substitution in industries linked to international production networks.

The domestic content of industrial production is not independent of the tariff regime. Other things being equal, low tariffs and/or duty drawbacks encourage high import content. By the same token it should be possible to use tariffs as a substitute for quantity restrictions over imports by TNCs when

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53 For a detailed discussion of the issues regarding TNC-dominated international production networks, see UNCTAD TDR (2002: Chaps. 2-3). For an account of the impact of TRIMs on policy space in Malaysia, a country extensively participating in global production networks, see Rasiah (2005).

54 The contribution of FDI to the balance of payments varies inversely with the share of profits in value added, the extent of its reliance on imports, and the proportion of the final product sold in domestic markets; see Akyüz (2005c: 30n).

they are unbound in the WTO or bound at sufficiently high levels. Imports by TNCs could also be discouraged by raising transaction costs through administrative means, as practised in some East Asian late-industrializers in support of domestic industries producing import-competing goods.

As long as there are no commitments for unrestricted market access to foreign investors, the constraints imposed by the TRIMs agreement could be overcome by tying the entry of foreign investors to the production of particular goods. For instance, a foreign enterprise may be issued a licence for an automotive assembly plant only if it simultaneously establishes a plant to produce engines, gearboxes or electronic components used in cars. Similarly, licences for a computer assembly plant can be tied to the establishment of a plant for producing integrated circuits and chips. Such measures, which raise domestic value added and net export earnings of TNC-dominated sectors, would not contravene the provisions of the TRIMs agreement.[55] However, they call for considerable bargaining power against TNCs. Such an approach was indeed an essential feature of investment coordination policies widely practised in East Asia, vis-à-vis not only foreign but also domestic investors.

There are also other measures that recipient developing countries can use as part of entry conditions for foreign enterprises. One such measure is export performance requirements without linking them to imports by investors. This would not contravene the TRIMs agreement since it would not be restricting trade (Bora 2002: 177). Governments in developing countries would also be free to require joint ventures with local enterprises or local ownership of a certain proportion of the equity of foreign enterprises. In fact, many of these conditions appear to be used widely by industrial countries in one form or another (Weiss 2006: 4-5).

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[55] I am grateful to B. L. Das for pointing this out to me.

Since the TRIMs agreement applies only to trade in goods, local procurement of services such as banking, insurance and transport can also be set as part of entry conditions of foreign firms in order to help develop national capabilities in services sectors. However, such a route would only be possible as long as developing countries continue to have discretion in regulating access of TNCs to services.

The existing GATS regime provides considerable flexibility to developing countries regarding policies for commercial presence in services. It allows them to choose the sectors in which they make liberalization commitments on a bilateral request-offer basis, and to determine the restrictions they would want to apply to market access and national treatment in each sector. It effectively adopts a positive list approach for sectoral commitments and a negative list for restrictions; that is, GATS disciplines apply only to sectors bound during negotiations (that is, included in countries' schedules of commitments), and countries can only apply the restrictions and exemptions explicitly specified in their commitments. This is a main reason why developing countries have generally been unwilling to include many sectors in their schedules of commitment.

Developed countries have been seeking fundamental changes in the modalities of GATS negotiations.[56] They called for the requested countries to compulsorily take part in plurilateral and sectoral negotiations, make binding commitments in a minimum number of sub-sectors in each of the four modes of supply (benchmarking), and to bind a certain percentage of the current level of applied liberalization, not included in countries' schedules of commitment so far. Requests have also been made to major middle-income developing countries by industrial countries for market access and national treatment in sectors such as finance, energy, telecommunications, maritime transport, computer and engineering services where TNCs from the latter countries have a clear competitive edge (Khor 2006). However, due to

[56] For a detailed description of the proposals and pitfalls for developing countries, see Das (2005).

strong opposition by some developing countries, the Hong Kong Ministerial Conference of December 2005 rejected both benchmarking and compulsory participation in sectoral negotiations while agreeing on the principle of plurilateral negotiations as a complement to bilateral negotiations.

The kind of changes in the modalities of GATS sought by developed countries would no doubt shrink policy space in developing countries a lot more than the TRIMs agreement. Prohibition of pre-establishment conditions would imply that various entry requirements that are permissible under TRIMs (such as production of certain goods, joint ventures or types of legal entity) as noted above would become illegal for FDI in services. On the other hand, the application of national treatment would have the same consequences as TRIMs in prohibiting domestic-content and forex-balancing requirements, aggravating the negative impact of FDI in services on the balance of payments.

Moreover, while national treatment in TRIMs applies to goods traded by investors, in GATS it would apply to the investor. This would preclude any preferential treatment of national suppliers of services even when the development of indigenous capacity and institutions, and broad-based provision of public services call for support and protection. As vividly illustrated in relation to the electricity sector, many policies used in both developing and developed countries to broaden access to electricity through monopoly concessions and subsidies, to address emergencies posed by financial crises through rate freezes and renegotiation of utility contracts, to promote innovative renewable energy technologies through discriminatory tariffs, and to achieve a better economic balance among different communal and racial groups could all come into conflict with a GATS-cum-investment regime promoting liberalization based on market access and national treatment principles.[57]

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[57] Cho and Dubash (2005). Rasiah (2005) provides an illustrative account of the implications of GATS and its extension for policy space in Malaysia.

In so far as mode 3 is concerned, GATS is an agreement on investment not trade.[58] It is indeed quite arbitrary to describe "commercial presence" as a mode of supply for services but not for manufactures or primary commodities. For some (e.g., Hoekman and Saggi 2002: 445), this provides a rationale for bringing them together under the same disciplines of a multilateral investment agreement. Failing that, the recent proposals by industrial countries for GATS are an attempt to expand multilateral commitments in investment in an area that matters most for TNCs, since in developing countries FDI typically faces greater restrictions in services than in manufacturing. But this also means that the concerns that underlie the opposition of developing countries to an MAI, shared in part even by some free-trade economists (e.g., Bhagwati 1998), apply with even greater force to these proposals. The logic of the matter now calls for taking mode 3 of GATS out of the WTO rather than promoting it as a multilateral regime based on principles of right to establishment and national treatment, and seeking to extend it to other sectors such as industry and agriculture.

### *4. Technology-related policies*

Several WTO agreements contain provisions that circumscribe technology-related policies in developing countries. The investment-related disciplines discussed above have direct repercussions by prohibiting incentives and restrictions for promoting technological progress and upgrading to higher-value-added, supply-dynamic and demand-dynamic products. Specific subsidies designed to promote adoption of advanced technologies and to support learning-by-doing come under the disciplines of the agreement on SCM. However, attention in popular debate has concentrated primarily on the agreement on TRIPS in large part because of its implications for such a delicate matter as public health in developing countries.

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[58] Strictly speaking this is also true for mode 4; it is not about trade per se but labour movements. There are no compelling reasons why such matters should be taken up in the WTO rather than, say, in the International Labour Organization (ILO) or UNCTAD.

The agreement on TRIPS is comprehensive and complex. There is a certain degree of ambiguity in the way it was drafted in order to reach consensus, giving rise to conflicting legalistic interpretations and making it difficult to draw its economic significance. Unlike other WTO agreements designed to promote free trade and competition, it is protectionist, even though its main goal is said to be "to reduce distortions and impediments to international trade." It establishes minimum standards that the countries are obliged to observe in establishing regimes for protecting intellectual property rights (IPRs) in a broad range of areas of which patents and, to a lesser extent, copyrights constitute the most important in terms of their implications for technology-related policies. Parties to the agreement are obliged to offer patents in almost all fields; give protection to owners of IPRs at no less than the level provided in the agreement; apply national treatment to foreign owners of IPRs registered with them; and observe non-discrimination among foreign holders of IPRs. A regime designed along these lines would include administrative mechanisms for examining and registering IPRs, and civil and criminal judicial procedures in their protection.[59]

The obligations of members are enforced through the WTO dispute settlement process. Retaliation can be in intellectual property rights, such as provision of a lower level of protection than that provided under the agreement to the nationals of a violating country, or suspension of national treatment. However, cross-retaliation is also allowed in all areas covered by the WTO, including restrictions over imports. This can in fact be expected to be more effective vis-à-vis developing countries than TRIPS-related retaliations because these countries lag considerably in the creation of knowledge and technology. Since TRIPS are no more related to trade than the so-called Singapore Issues, this, in effect, amounts to the application of trade sanctions for upholding international law in a non-trade area, and has a certain degree of parallel with the use of trade sanctions for non-trade matters in the multilateral system, such as those imposed under Article 41

[59] For a detailed description of rights and obligations under the TRIPS Agreement, see Das (1999: Chap. VII.2), Correa (1998, 2000) and Watal (2002).

of the United Nations Charter. But it does not have the same rationale because, *inter alia*, what is sought here is not the provision of global public goods but protection of private interests mainly in industrial countries.[60]

The key issue is not whether developing countries need a regime for protecting IPRs. Introducing such a regime, as in the case of competition policy (see Singh 2002), may indeed be in the interest of some, if not all, developing countries even though, as noted, many industrial countries did not have effective IPRs regimes at similar levels of development. However, the issue is about the extent to which IPRs regimes are shaped by the needs of developing countries as users of knowledge and technology rather than their creators in more advanced countries. To the extent that the underlying minimum standards for harmonization of IPRs are dominated by the latter, they could have significant adverse effects on technological progress in developing countries by narrowing the space for policies more suited to their needs.

The asymmetry between industrial and developing countries in the creation of knowledge and technological innovation is perhaps greater than that in any other area, including FDI. The share of developing countries in world R&D spending is less than 10 per cent, and is heavily concentrated in a few countries such as Korea. Similarly a very large proportion of technological patents originate from industrial countries. Applicants from such countries accounted for more than 95 per cent of the total patents granted in the United States during 1977-1996. Ten developed countries accounted for more than 90 per cent of the patents granted by the United States Patent and Trademark Office during 1997-2004, of which the applicants from the United States alone had over 53 per cent and Japan 20 per cent. By contrast, the share of the top 10 developing countries barely reached 7 per cent. In Brazil applications for IPRs by foreign residents, notably from the United

60 This does not mean that in reality all UN sanctions promote global public goods – for an assessment, see Paul and Akhtar (1998).

States and Europe, accounted for 92 per cent of the total in 1996 while in Mexico this figure was close to 99 per cent. For middle-income countries as a whole, this figure is over 97 per cent.[61]

This asymmetry is also reflected by trade patterns. Although trade statistics show a rapid expansion of technology-intensive, high-value-added exports from developing countries, in reality these countries are often involved only in the low-skill, assembly stages of production, using technology-intensive parts and components imported from more advanced countries. In fact developing countries still account only for 10 per cent of world exports of products which score high in R&D content, technological complexity and/or economies of scale (Akyüz 2005c: 21-27).

The TRIPS agreement entails various costs for developing countries. First, there are administrative costs of establishing a regime for intellectual property protection (UNCTAD 1996). These would be insignificant in industrial countries since the agreement is basically modelled on their prevailing regimes. Second, IPRs tend to raise the costs of protected products to consumers. This is not only because the agreement could encourage the producers of such products to raise prices, but also because it would prevent production or raise the cost of cheaper substitutes, notably in computer software, pharmaceuticals and chemicals. Finally, protection of IPRs impedes the access of producers in developing countries to advanced technology through means such as imitation and reverse engineering, thereby slowing technological progress and catching up with advanced countries. It strengthens the monopoly power of owners of IPRs in denying access to potential competitors or raising the cost of technology transfer.[62] On some

61 On the distribution of R&D and patent applications between developed and developing countries, see UNCTAD (2005: Chap. 3); Kumar (1997: Table 1); World Bank (2002: 136); and Shadlen (2005: Tables 1&2).

62 An example was cited by Khor (2005: 24-26) where an Indian firm was denied access by foreign patent holders to technology to produce a more efficient and environment-friendly coolant for refrigerators and air conditioners.

estimates, net gains from TRIPS to the United States due to patent rights are 13 times the gains from the UR liberalization of industrial tariffs, while for Korea the cost of its TRIPS obligations is 18 times as large as its gain from increased market access in industrial products (Finger 2002).

It is generally argued that the burden is particularly onerous for the poorest countries (World Bank 2002: Chap. 5). This is certainly true for administrative costs of establishing an IPRs regime and for access to essential products that come under protection such as drugs and vaccines. However, as noted in the discussion on industrial tariffs, the challenge of industrial upgrading becomes more demanding at the intermediary stages of development. In this respect, low-income countries relying on primary commodities and resource-based products are unlikely to face serious constraints from the TRIPS agreement. These countries are often unable to produce the machinery and equipment utilized for the exploitation of their natural resources, and the technology needed is often embodied in the imported capital goods and intermediate products. Imitation of foreign technology gains importance for middle-income countries not only because they often have the capacity to do so, but also because this is an important step in industrial upgrading. For such countries, the TRIPS agreement could prove to be more restraining than for countries at rudimentary stages of industrial development. By contrast, a global system of protection of IPRs would be beneficial to countries at advanced stages of industrialization when imitation is replaced by innovation. Indeed, there is evidence showing that protection of IPRs tends to weaken after early stages of industrialization as countries develop the capacity to imitate, and then to strengthen with the development of innovative capacity (Maskus and Penubarti 1995).

As for other WTO agreements, significant benefits are claimed to developing countries from the TRIPS agreement. These include acceleration of innovations not only in developed countries with strong international spillovers, but also in developing countries themselves. The agreement is expected to encourage technology transfer to developing countries through imports of high-tech manufactures, FDI and contractual arrangements, and increased location of R&D activities of TNCs in their subsidiaries in developing countries.[63]

However, there is little empirical support to the claim that strong IPRs encourage innovation. This is particularly true for developing countries where studies show a close association between weak IPRs and innovation, in large part because weak protection encourages absorption of R&D spillovers from more advanced countries. On the other hand, there is considerable ambiguity regarding the impact of strong protection of IPRs abroad on servicing foreign markets through exports, licensing and FDI.[64] Stronger protection of IPRs could reduce the need of their owners to be present in developing countries through FDI, allowing them to service these markets through licensing and exports. Indeed, one of the benefits sought by TNCs from the TRIPS agreement was to be freed from the obligation to locally exploit patented inventions or transfer technology to local firms (Correa 1998: 5).

While import of high-tech manufactures, FDI flows and R&D activities of TNCs in developing countries have all been growing in recent years, it is not clear whether these are related to greater protection of IPRs and reflect increased transfer of technology.[65] Much of the increased FDI inflows and imports of high-tech parts and components in developing countries is the result of rapid spread of international production networks in search of cheaper locations where the participation of host countries remains at the lower end of technology (UNCTAD TDR 2003: 82-83). As in the case of other incentives, stronger protection of IPRs alone does not necessarily lead to higher FDI in developing countries, including investment designed to

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[63] For these arguments and empirical evidence, see Correa (2000: Chap. 2), World Bank (2002: Chap. 5) and Kumar (2003).

[64] For a discussion of various modes of transfer of technology, see Hoekman, Maskus and Saggi (2004).

[65] UNCTAD (2005: xxvi) estimates that the share of foreign affiliates in business R&D in the developing world increased from 2 per cent to 18 per cent between 1996 and 2002.

relocate R&D activities abroad. Indeed recent FDI flows have been towards countries with weak IPRs regimes but strong imitation capacity, such as China and Brazil.[66] More importantly, as already noted, increased FDI and R&D activities by TNCs in developing countries would not necessarily entail greater transfer of technology and help them build national capacity in the absence of active policies designed for this purpose. Again, while there is some evidence of an association between high-tech imports by developing countries and stronger IPRs, this does not necessarily imply internalization of the technology embodied in such products and technological progress.

How much policy space does the TRIPS agreement leave to developing countries for their access to knowledge and technology created in industrial countries and for technological upgrading? First of all, it should be noted that the agreement does not constrain all possible instruments of technology policy, and several policies for technological capability-building at the firm level still remain outside WTO disciplines (Rasiah 2005: 457). More importantly, as extensively discussed in the literature on the impact of the agreement on policy space, there are several flexibilities which the developing countries can make use of in the design and application of a regime for the protection of IPRs.[67]

From the point of view of technology-related policies and transfer of technology, a central issue is patentability. The agreement leaves considerable discretion as to what kind of knowledge is eligible for patenting. It stipulates invention and industrial application as the two main requirements for patentability and provides some exceptions − e.g., for inventions that are disruptive for public order and morally unacceptable.

[66] In World Bank (2002: Table 5.1) simulations greater increase is expected in Colombia and Chile with little industrial capacity but strong IPRs regimes than in India and China. Maskus (2005: 54) argues that on the basis of strength of IPRs alone, recent FDI flows to developing countries would have gone mainly to sub-Saharan Africa and Eastern Europe.

[67] Important contributions include Third World Network (1998), Correa (2000) and Shadlen (2005).

In recognition of practical difficulties, however, it does not provide a definition for invention. With some exceptions this is also true for national laws. This means that, within the limits of general standards, countries have flexibility in determining what they consider as invention and in excluding discoveries from patenting. While industrial countries have increasingly opted for a broader concept, most developing countries may need to apply a narrow concept of invention since their industrialization depends not so much on innovation as on transfer and adaptation of technologies already in use in more advanced countries. This was very much the route taken by late-industrializers in Asia, including Japan (Kumar 2003).

Even though there is an obligation in the agreement to grant patents whether the products are locally produced or imported, for developing countries it is important that owners of invention should not enjoy automatic exclusive rights if the processes in question are not domestically applied and the products are not domestically produced. This means that these countries should be able to issue compulsory licences when such products are made available through imports alone. This is consistent with the freedom granted to countries in the agreement in determining the grounds on which such licences could be granted. It is also consistent with the objective of the TRIPS agreement to promote transfer and dissemination of technology since in this regard domestic application is more effective than imports. It could also be argued that without domestic application, disclosure and sharing of the knowledge, as provided by the agreement, would be incomplete. Issuance of compulsory licences on such basis is permitted by IPRs regimes in Brazil and India, but the matter is contentious in the WTO and needs to be resolved once and for all (Shadlen 2005: 22-23; World Bank 2002: Box 5.2).

Such a practice could encourage non-resident patent holders to invest in developing countries in order to enjoy exclusive rights, particularly if coupled with high tariffs on patented products. The importance of tariffs in this context derives from the infant-industry argument; that is, domestic producers who obtain compulsory licences for the products in question would likely be high-cost producers even in the absence of licence fees. On the other hand, as long as there is no commitment in the WTO to provide market access to foreign investors, it should be possible for a country to extract appropriate terms and conditions for the transfer of technology and know-how to national enterprises as part of their entry conditions to the domestic market.

The agreement also stipulates restrictions on the exercise of control by patent holders over their rights. An important provision in this respect is the disclosure requirement designed to allow access by third parties: inventions should be disclosed in a manner which is sufficiently clear and complete for a skilled person in the art to carry out the invention. This, together with various general exceptions regarding the use of patented knowledge for experiments and tests, and the doctrine of exhaustion and parallel imports, could help firms in developing countries to use the information to adapt the technology to their local circumstances and develop further inventions. Finally, the agreement also allows governments to issue compulsory licences for patents registered with them if, among other things, there are justifying circumstances such as emergency and extreme urgency, or the holder refuses to deal or resorts to anti-competitive practices. Anti-trust regulations and competition policies, as provided by Article 40 of the agreement, including price controls, can play an important part in preventing abuse of monopoly power and restrictive business practices by holders of IPRs and facilitating transfer of technology.

There can be little doubt that the TRIPS agreement has brought important restrictions over patent policies in developing countries. Certain measures used by developed countries in the course of their industrialization such as discrimination against foreign patent applicants or exclusion of sectors such as chemicals and pharmaceuticals are no longer available to countries striving for industrial catch-up (Chang 2001). Nevertheless, as noted by several critics of the agreement, it still leaves some room for manoeuvre because of the way its provisions are formulated as well as the absence of specific rules and obligations in certain areas.[68] Developing countries could exploit the space available not only by establishing appropriate national legislation and practices, but also by securing agreement in the WTO on certain interpretations of the provisions of the TRIPS agreement, so as to widen their freedom in determining patentability and issuing compulsory licences. Moreover, it is also important that they resist further erosion of space for technology-related policies which the industrial countries now appear to seek in the World Intellectual Property Organization (WIPO) through their Draft Substantive Patent Law Treaty proposal designed to establish specific and uniform substantive legal standards related to the concept of invention and disclosure requirements.[69]

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68 See, for instance, Correa (2000: 97-98) and Shadlen (2005: 27).

69 On the possible repercussions of the WIPO patent agenda for developing countries, see Correa and Musungu (2002).

# 4 Conclusions

WHILE focussing on the question of national policy autonomy, a key proposition of this paper is that in a world where economies are closely linked through flows of goods, services, money, capital etc., there is a strong rationale for multilateral disciplines over national policies. However, certain conditions need to be met in order for such disciplines to help promote international economic stability, and broad-based economic growth and development. First, there should be coherence among arrangements in different spheres of economic activity so that they reinforce, rather than undermine and destabilize, each other. Second, the rules should be even-handed across countries in terms of flexibility and space they allow. All these call for a global governance system that secures, *inter alia*, voluntary, full and equal participation in the formulation of multilateral disciplines.

Current multilateral arrangements barely meet these principles. Coherence between trade and finance is not secured because of lack of multilateral disciplines over macroeconomic and exchange rate policies of countries that matter most for global monetary and financial stability, and the priority attached to meeting international financial obligations at the expense of trade and growth. This constitutes the single most important threat to the stability and openness of the trading system. On the other hand, conditionalities attached to multilateral lending by the BWIs place constraints not only on macroeconomic and financial policies, but also on broader social and economic development strategies in developing countries, and these extend beyond what is needed for international economic stability and financial integrity of these institutions.

The trading system does not fare better in terms of the balance between developed and developing countries. Although WTO rules and obligations are legally equally binding for all parties, they are designed primarily to accommodate the development trajectories of industrial countries, imposing tighter effective constraints over policies in developing countries, particularly those at intermediate stages of industrialization. This is true, above all, in areas of economic activity where there are inherent asymmetries between developed and developing countries, such as FDI and intellectual property rights. Furthermore, as shown by several examples above, the WTO rules do not constitute a coherent system based on a consistent application of principles for global collective action designed to provide global public goods, but a pile of *ad hoc* concessions and exceptions exchanged in pursuit of self-interest by its more powerful members.

Various proposals for improvement are made above to bring about coherence between trade and finance, and to strike a balance between multilateral disciplines and policy flexibility, and between developed and developing countries. It is argued that balanced and effective multilateral disciplines in monetary and financial matters would not be possible without establishing the autonomy of the IMF vis-à-vis its non-borrowing members, particularly, but not only, major industrial countries. This necessitates a fundamental reform of its mandate, resources and governance. Attention should also be given to reforming the modalities of lending and conditionality by both the Fund and the World Bank so as to allow greater freedom to the borrowers in choosing their development policies and strategies without weakening the core responsibility of these institutions and jeopardizing their financial integrity.

In the trading system the main challenge is how to ensure that rules and obligations entail similar and appropriate effective constraints over policy in countries at different levels of development. Here it is argued that differential needs should be taken into account in the design of the rules rather than introduced as exceptions. Of the four areas of policy examined above, developing countries need much greater space and flexibility in the use of industrial tariffs and subsidies than is actually provided. Relaxation of some of the constraints in investment and technology-related policies (such as national treatment) is also called for, but in these areas it is more important to avoid further erosion of policy space.

The analysis above also shows that despite the proliferation of multilateral rules and obligations, there is still room for manoeuvre within the confines of the multilateral system. Moreover, a number of important areas of policy remain outside the multilateral disciplines. There are hardly any rules in the international monetary and financial system obliging countries to adopt a particular exchange rate or capital account regime − as noted, this is, in fact, a shortcoming of the multilateral system contributing to global economic instability. Similarly there are no hard and comprehensive multilateral rules in several areas such as labour mobility, FDI, trade in services and competition policy.

It is true that multilaterally agreed rules are not the only or even the most important constraints over policy autonomy in developing countries. For many poor countries dependent on official assistance, the space left by multilateral rules is constantly eroded by *ad hoc* and excessive conditionalities of the BWIs and major donors. Furthermore, obligations undertaken by developing countries in bilateral and regional trade and investment agreements with major industrial countries extend well beyond those undertaken in multilateral agreements. Finally, financial markets and TNCs exert even a stronger influence than multilateral rules by penalizing policies that deviate from liberal orthodoxy.

Several of these external constraints result either from deliberate policy choices − as in bilateral or plurilateral commitments − or from domestic policy failures to resolve deep-seated structural problems. Many middle-income countries, particularly in Latin America, have been unable to remove their fiscal, savings and foreign exchange gaps and have thus become heavily dependent on foreign capital, while others at similar levels of development, notably in Asia, have been able to do so and achieved a relatively high degree of autonomy vis-à-vis international financial markets and the BWIs.

Differences among countries in their willingness to put on the "Golden Straightjacket" and to exploit the policy space allowed by existing multilateral rules and practices are an important reason why there is still considerable policy diversity in the developing world, particularly in money and finance. According to an index of financial openness, the financial system in 1997 in some developing countries including Argentina and Mexico was more open than in the United Kingdom and the United States, while Brazil, India and Malaysia came at the bottom of the list as economies with largely closed capital accounts (Dailami 2000: Table 15.3). This variation cannot be explained by differences in the extent to which these countries were subjected to IMF pressures for financial opening − the Washington Consensus in its original form and IMF country programmes did not include capital account liberalization even though the Fund ideology was very much in favour of it.[70] Deliberate policy choices of the countries concerned, including attempts to find quick fixes for chronic fiscal, savings and balance-of-payments deficits by attracting private capital, played an important part.[71]

There are also specific examples of how countries' treatment of capital flows is dictated by deliberate policy choices rather than multilateral rules or external pressures. Chile and Thailand had similar macroeconomic and structural conditions during the boom in private capital inflows in the 1990s, but while Chile went for a regime of control over short-term capital inflows through unremunerated reserve requirements despite the misgivings of the IMF, Thailand in effect encouraged such inflows by establishing the Bangkok International Banking Facility (UNCTAD TDR 1998: Chap. 3).

70 On the Washington Consensus, see Williamson (2003), and on the Fund's approach to capital account liberalization, see Akyüz (2005b: sect. G).

71 For the Latin American experimentation with neoliberalism, see UNCTAD TDR (2003: Chap. VI).

Another example is from crisis response. During 1997-1998 Korea and Malaysia were in similar macroeconomic conditions and they both faced liquidity problems. But their crisis responses were crucially different; Malaysia went against the advice coming from Washington and imposed temporary standstills and exchange controls in order to check financial meltdown and create room for expansionary monetary policy for recovery, while policy in Korea was designed to keep the capital account open as long as possible and engage in fruitless negotiations with creditors until it was no longer possible to remain current on its external obligations despite a massive IMF bailout. Indeed, it was also recognized in a subsequent report by the Government of Korea that "many of those who have analysed Korea's 1997-1998 crisis contend that Korea could have solved its liquidity problems sooner had a standstill mechanism been in place at the time it requested IMF assistance" (G-20 1999: 13). Clearly such differences in policy can be explained primarily by differences of vision and perception rather than policy space.

There are also significant differences among developing economies in their degrees of openness to foreign trade and investment resulting from deliberate policy choices. In trade large differences are observed not only in export and import ratios, which are strongly influenced by non-policy factors such as size and natural resource endowments, but also in tariff regimes. Average bound industrial tariffs for developing countries, excluding LDCs and first-tier NIEs, vary between 5 and 70 per cent while average applied tariffs vary between 2 and 31 per cent (Fernandez de Cordoba and Vanzetti 2005: Table A6). Many countries which have undertaken voluntary and unilateral trade liberalization still have considerable space in so far as their WTO commitments are concerned, either because an important part of their tariffs is unbound or because their applied tariffs are well below bound tariffs. But such space is rarely used even at times of serious balance-of-payments difficulties, as was the case in Argentina during the 1990s.[72]

[72] By adopting a quasi-currency board, Argentina had denied itself the exchange rate as an instrument of policy for external adjustment. It started experiencing payments

Diversity among countries at similar levels of development is also marked in other areas of policy, including those which are and are not subject to multilateral disciplines. While some countries pursue an open-door policy for foreign investment, others pick and choose where to allow the TNCs to invest, how much they can own and how they should produce. Technology policies, including R&D subsidies, are seen as a key instrument of upgrading in more dynamic economies whereas in others unbridled competition is expected to settle the matter. Generally, policy diversity spans the entire spectrum between the neoliberal approach favouring rapid liberalization and full integration into the global markets, and the approach that recognizes the limits of both markets and government intervention and seeks strategic integration. Contrary to the predictions of free-market pundits, economic globalization is not leading to the demise of the nation-state and putting all policy makers in the "Golden Straightjacket" of the free market, even though there has been a certain degree of harmonization of policies in the direction dictated by the dominant neoliberal ideology.[73]

All these imply that a return of the development paradigm to replace orthodox free market ideology requires action on three fronts. First, there is a need to restructure multilateral disciplines to widen the boundaries of policy intervention for development. This should be an exercise in rationalization, rather than doing away with multilateralism. Second, for some countries there may be both the need and scope to regain the policy space and flexibility lost through unilateral action. It is true that policy reversal can be quite costly, but this may be worth considering when potential benefits are large. Finally, it is important to use the space that is available − something that calls for a fundamental rethinking of economic policy in many developing countries.

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difficulties as a result of a sharp appreciation of its currency and a rapid increase in imports, including consumer durables, and drops in capital inflows after the Mexican and East Asian crises. Despite deepening recession and mounting unemployment, tariffs on consumer goods were raised to their WTO limits only in 2001 – see Lederman and Sanguinetti (2003).

73 See Weiss (2005b) and Mosley (2005) on the limits of harmonization.

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# MULTILATERAL DISCIPLINES AND THE QUESTION OF POLICY SPACE

In a world characterized by increasing interdependence, there is a strong rationale for multilateral disciplines over national economic policies. To be effective in promoting global economic stability, however, there should be coherence among such disciplines in the various spheres of economic activity as well as an appropriate degree of flexibility for domestic policy-making.

Current multilateral arrangements come up short on both these fronts. Coherence is lacking between the international systems of trade – which is governed by a rules-based regime with enforceable commitments – and finance – where there are no multilateral disciplines over macroeconomic and exchange rate policies of systemically important countries. Furthermore, the multilateral trade and finance arrangements impose tighter effective constraints on policy-making capacity in developing countries compared to developed countries, unduly eroding the former's policy space to pursue their development objectives.

This paper argues the need for reform of the existing multilateral disciplines to enhance coherence between trade and finance and to strike a better balance among countries. The author offers specific suggestions towards this end but also points to some areas where significant policy space for developing countries still exists within the present framework of multilateral disciplines.

**YILMAZ AKYÜZ** *is former Director of the Division on Globalization and Development Strategies at the United Nations Conference on Trade and Development (UNCTAD).*

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