

AGGREGATE GROWTH

It is generally believed that economic growth in the underdeveloped countries has been slower than that in developed countries in recent years. If we define growth as a percentage of increase in national product, this belief is not so—the two areas' incomes grew at an average compound rate of about 4.5 percent annually from 1950 to 1962 with the LDC rate if anything slightly higher than that of the Atlantic countries. Growth of per capita income, however, has been faster in the Atlantic countries, the amount of the spread from year to year being influenced not only by faster population growth in LDC's, but also by changes in U.S. income growth, because the United States accounts for more than half of Atlantic income.

If it were not for rapid population growth in the South, economic growth rates in the two regions would be about the same (other things being equal). With annual growth in per capita incomes of 3 percent then entirely feasible, incomes per head would double every 23 years.

It is largely on the basis of this concern for small differences in growth rates and on the alleged limitations of growth caused by lack of foreign exchange that underdeveloped countries in economic rationality can justify their preoccupation with trade and aid concessions from the North. It is possible to argue one or both of two cases to support the need for faster export growth as a condition of faster output growth: (1) Foreign exchange limitations create a barrier to output growth; (2) domestic savings or domestic markets for goods cannot be increased readily, so that increased imports are the only way to increase investment; or increased exports the only way to find markets (because domestic demand is small, or domestic productive factors are immobile as among industries). Both arguments are made by underdeveloped countries.

Industrial countries, on the other hand, generally do not argue so strongly for trade expansion on these grounds. Their case for more trade is to a greater degree on the comparative cost arguments and, in the case of smaller countries, the desire to benefit from economies of scale.

In any event, there is clearly no unique relation between trade and economic development. The percentage growth of Atlantic Community exports was nearly twice as great as its income growth during the past decade; underdeveloped countries' exports rose a little slower than income. Yet income in the two areas grew at nearly the same rate. Table 2 compares industrial and underdeveloped countries' trade growth from 1950 through 1965.

These data underline the error inherent in equating income growth and trade growth uniquely for all countries. The industrial countries' prosperity has been marked by rapid increases in trade, probably reflecting: (1) Dismantling of the trade restrictions created during the depression of the 1930's, and maintained until after World War II—in effect a sort of catching up to normal trade patterns after a long period of restriction; (2) increasing specialization in production of manufactures, made possible by increases in demand, and encouraged by preferences for widely advertised products; (3) the internationalization of tastes made possible by modern communications, and encouraged by the growth of international corporations, which are also

often their own customers in world trade; (4) the marked and continuing decline in transportation costs in this century.

TABLE 2.—GROWTH AND SHARES OF EXPORTS, 1950-65

	Average export growth rates (percent per year)		Shares of total exports ^a (percent)		
	1950-60	1960-65	1950	1960	1965
Industrial countries.....	8.6	8.4	66	76	78
Underdeveloped countries.....	3.6	5.8	34	24	22

^a Excludes trade between Communist countries; includes free world exports to Communist countries.

Source: UNCTAD, Handbook of International Trade Statistics, Doc. E/Conf. 46/12/add. 1, Feb. 28, 1964; United Nations, Monthly Bulletin of Statistics, May 1966.

Growth of the underdeveloped countries has taken place under a variety of trade conditions. They have benefited, either as exporters or importers, from the factors listed above, but the results for trade have been generally modest. The situation varies greatly among countries. The basic points accounting for the difference seem to be: (1) the buoyancy of world demand for manufactures has allowed all Northern countries to share, albeit unevenly, in the rapid growth of trade; (2) often lacking that opportunity, some Southern countries, usually the larger ones, were able to expand rapidly by maintaining the traditional but slow-growing exports, substituting domestic industrial production for imports, and using the foreign exchange savings for importing capital goods; while others grew either by outpacing the average LDC export performance or else failed to grow. The data of table 2 offer some evidence of changes in this pattern since 1960. Southern exports have increased faster than in the preceding decade, and their exports of manufactured products have continued to rise at a faster rate than all exports combined. It is still too early to say whether this trend marks a shift in the forces that propel Southern economic growth, or portends a rise in aggregate growth rates. It could be largely the reflection of short-run fluctuations in commodity price levels.

The UNCTAD resolutions and the report of its Secretary-General stressed inadequate command over imports as the major factor in slow growth. While there is evidence to support this claim, an examination of all the facts supports a somewhat more complex interpretation.

First, sustained economic growth is almost always associated with at least some growth of imports, often financed in part by foreign capital. There have been a few exceptions in modern times, necessarily associated with major efforts at import substitution. But to cite the exceptions, such as Brazil, the Soviet Union, and possibly Australia in recent years, only stresses the special conditions required—a large domestic market and a varied natural resource base.

Second, the smaller the country, the greater the need for trade growth as a condition of income growth. Small countries (less than 10 million population) that grow fast always have a rapid growth of imports.

In most cases, import growth is somewhat faster than income growth for small countries. The principal exceptions are Venezuela,

where changes in oil company imports of capital equipment have been an important source of variation; and Israel, faced with serious trade deficits and aided by capital inflows and a rapidly growing home market for import-substituting industry and agriculture.

Third, rapid import growth is not a necessary condition for rapid income growth, where the market is large enough to allow domestic industrialization, or substitution of domestic for imported commodities. Thus, between 1950-52 and 1961-64, Mexico's income grew at the annual rate of 5.6 percent, while imports increased at the rate of 4.7 percent. For the Philippines the comparable figures are 5.4 percent and 3.8 percent. In Brazil and Burma, imports actually declined over the period.

In sum, rapid peacetime growth of imports has been a sufficient condition for the growth of income in the South, but not a necessary one. The reasons for the association are clear. Steady growth of imports is financed either by an equivalent export growth or a capital transfer. In the latter case, the recipient benefits from increased investment without the immediate need for corresponding savings. The continuation of such a transfer normally means that private or public investors in the North are confident of the capital importer's economic potential.² If the import increase is largely export financed, as is the case for most of the fast-growing small countries, then it implies that the country is able to compete effectively in world markets, and is presumably in a favorable growth situation.

If, on the other hand, a developing country finds itself unable or unwilling to finance steady import increases by exports or borrowing, the record shows that rapid growth may still be possible if the domestic market is large enough and the resources and organization are present to permit large-scale import substituting investment. In such cases, the close relationship between trade and growth recently observed in the North no longer holds, and import substitution becomes the leading sector in growth.

TABLE 2A.—GNP GROWTH AND TRADE GROWTH, FAST-GROWING LDC'S, 1950-52 TO 1961-64
(Annual increases; countries listed in decreasing order of GNP growth)

Country	GNP growth rate (percent)	Trade growth * (percent)	
		Imports	Exports
Populations under 10 million:			
Israel.....	10.0	6.0	17.0
Jordan.....	^b 9.8	10.5	13.1
Iraq.....	8.4	9.7	11.7
Trinidad.....	^b 7.6	9.2	9.6
Jamaica.....	7.0	9.4	12.3
Venezuela.....	6.7	1.4	4.2
Puerto Rico.....	5.6	9.1	10.0
Nicaragua.....	5.3	8.1	7.2
Ghana.....	5.3	7.6	3.0
Populations over 20 million:			
Mexico.....	5.6	4.7	3.7
Brazil.....	5.6	1.6	-2.1
Thailand.....	5.4	12.6	4.9
Philippines.....	5.4	3.8	3.7
Burma.....	5.2	-1.1	3.5
Turkey.....	4.9	2.9	3.6

* Corrected for terms of trade changes, 1962 equal 100.

^b 1955-57 to 1961-64.

Source: Computed from U.N. data.

² Of course, the motive for the transfer may be political. In extreme cases (Vietnam, Korea), long-term potential is virtually irrelevant.

Some economic writing insists that the trade development relationship is essential to growth. In fact, the world allows a variety of sources of growth; a high and fast growing level of trade is perhaps indispensable only for small nations or those with a particularly uneven distribution of resources. The combined populations of 70 developing nations with less than 10 million inhabitants each do not equal half the population of India, but they exercise together a disproportionate political weight in international forums. This fact has shaped the nature of the UNCTAD recommendations, particularly its insistence on the international element in growth.

II. PRESENT SITUATION AND PROSPECTS—COMMODITY TRADE

About 85 percent of LDC exports are primary commodities—food, tropical beverages, agricultural raw materials, fuels, and mineral ores, some domestically refined for further processing after export. Table 3 shows the trends, by category, in recent years.

No matter what the long-range hopes for LDC manufactured exports may be, most underdeveloped countries today must rely primarily on commodity trade. Prospects for trade in commodities vary greatly, both by product and by country.

World demand for LDC commodities in the aggregate rose slowly during the decade 1952–62. The principal factors were probably slow growth of demand for food in rich countries; substitution of synthetics for natural raw materials (rubber, plastics, synthetic fibers, detergents); a tendency for industrial buyers to use smaller amounts of raw materials per unit of final output; agricultural protectionism in the Atlantic Community; low elasticity of demand for commodities in the aggregate with respect to price changes (although the actual market situation product by product is complex). During the 1950's, these tendencies were reinforced by the decline in prices, following the speculative effects of the Korean war.

TABLE 3.—LDC EXPORTS BY CATEGORY, 1956–64

[In billions of dollars]

Year	Food and beverages	Agricultural raw materials and mineral ores (not refined)	Petroleum and other fuels	Manufactures (including refined ores) *	Total
1956.....	8.0	7.0	6.5	3.3	24.8
1958.....	8.2	6.2	7.4	2.8	24.6
1960.....	8.1	7.6	7.7	3.8	27.4
1962.....	8.5	7.3	8.9	4.2	28.9
1963.....	9.4	7.6	9.6	4.8	31.5
1964.....	10.3	7.7	10.8	5.5	34.4

* In recent years, refined ores have accounted for \$1,000,000,000 to \$11,700,000,000 of the LDC exports under this category. The estimated figures for 1960 through 1964 are, in billions of dollars: 1960, \$1.4; 1961, \$1.4; 1962, \$1.4; 1963, \$1.5; 1964, \$1.7. (Cf. United Nations, Monthly Bulletin of Statistics, May 1966.) Rows may not add to totals shown because of rounding.

Source: United Nations, Monthly Bulletin of Statistics, March 1962 and March 1966.

There were several factors at work tending to maintain and increase LDC export supplies despite the slow growth of demand. The principal ones were immobility of resources in LDC's, leading to continued production of traditional export crops even when demand was un-

favorable; high prices during the Korean crisis bringing expansion of supply for many products, notably minerals and tree crops; new countries, seeking additional foreign exchange sources, turning to expanded commodity production as the easiest way to compete in world markets. In the past 15 years, regions that previously exported little coffee, tea, or petroleum have entered the world market as significant producers.

The net effect of LDC export supply growth outpacing demand growth for their products was a general reduction in commodity export prices during the period. The UN index of LDC export prices declined from 113 in the 1951 boom to 100 in 1952, and drifted down to 84 in 1962. Subsequently, agricultural commodity prices rose and LDC export unit values were about 5 percent above 1962 levels at the end of 1964. Atlantic Community export prices meanwhile remained relatively stable, so that terms of trade (export price index divided by import price index) of LDC's declined by about 8 percent over the 1952/53-1962 decade, and by about 5 percent for the period 1952/53-1964.

Although the quantity of LDC exports rose more slowly than the Atlantic Community's, there was a substantial increase in total LDC export quantity and value during the decade following the conflict. LDC commodity export values rose from about \$18 billion equivalent in 1952 to about \$28 billion in 1964.³ If these figures are corrected for terms-of-trade declines during the interval, purchasing power of LDC commodity exports apparently rose by about \$7 billion equivalent during the 13-year period, or at the compound rate of 2¾ percent annually. This is much slower than the real growth rate of Atlantic Community exports or of LDC manufactured exports, but it is by no means negligible, compared with LDC export growth over the past 50 years. A continuation of this trend would result in a doubling of 1952 commodity export value by 1977.

In discussing the commodity trade situation of some 70 countries, there is a great deal of variation, perhaps too much to allow any all-inclusive statement. However, a few points seem clear:

1. Many Latin American and Asian countries will be able to rely less and less on commodity trade for financing import growth.
2. The Middle East and Africa are better off, thanks largely to petroleum in the former region and favorable supply conditions for a number of products in the latter.
3. Two conditions will tend to favor the growth of any country's commodity export trade:

Low-cost productive potential, even if the particular commodity faces sluggish world demand (as in the postwar expansion of African tea and sisal exports).

Specialization in products with good demand prospects (as in Peruvian fishmeal trade, African copper exports, Middle East oil, or Malayan tin).

4. For most countries, this last condition does not apply. Those that are semi-industrial (India, Brazil, Argentina, Mexico, Taiwan) can hope to shift increasingly from commodities to manufactured exports, although this is no easy task. Those whose industry is not yet established have even fewer trade alternatives. For them, unless tourism or other service industries can be developed, the foreign ex-

³ UNCTAD, "Handbook of International Trade Statistics" (E/Conf. 46/12 Add. 1), Feb. 28, 1964; "Monthly Bulletin of Statistics," April 1965.

change limitation is likely to loom as a major obstacle to desired rates of growth.

International action in the sphere of commodity policy has been concerned with three kinds of measures: (1) trade liberalization; (2) transfer of income from commodity importers to exporters; (3) stabilization of commodity prices and export earnings.

TRADE LIBERALIZATION

In theory improved market access is the most efficient way to increase LDC export earnings, because it increases the flow of trade and raises the earnings of exporters, with no corresponding income transfer from rich to poor countries. A liberal trade policy benefits both exporting and importing countries by raising the real incomes of both, but it may create adjustment problems for high-cost producers or revenue problems for governments who benefit from customs duties and fiscal changes. Because agriculture in the North is a relatively declining industry, which resists such adjustments, there is little likelihood that barriers to imports of competing crops (Southern commodities that compete with domestic production in the North) will be reduced. Some progress might be made, with relatively limited effects on trade, for such noncompeting products as tea, coffee, cocoa, and tropical hardwoods.⁴ Thus, although LDC exports to the North might well increase by anywhere from \$3 to \$5 billion annually as a result of free trade in commodities, the immediate prospects for change are slim in the short run. For the time, agricultural protectionism seems to be on the increase.

COMMODITY AGREEMENTS

If the prospects are modest for increasing world income through freer trade in commodities, they are perhaps slightly greater for transferring income from rich to poor countries by commodity price fixing. The persistent international interest in "stabilization" of commodity prices is largely an effort to make importers pay more than they would in a free market. Discussion of such agreements is usually confined to noncompeting exports (coffee, tea, cocoa, sugar, bananas, spices, tin) and price-fixing agreements for these products could be used to transfer an average of perhaps \$1 billion annually from North to South over the decade 1965-75. If extended to competing products, as proposed by the French Government, price fixing could result in a far larger transfer. For example, if price fixing could increase the south's \$17-\$18 billion annual revenue from commodity exports to the North by 20 percent, the total annual transfer would be of the order of \$3.5 billion initially. However, a generalized price-fixing policy not only invites substitution of synthetics, but also encourages import substituting domestic production in the North. The common agricultural policy of the EEC is aimed in part at this latter goal. Therefore, the longrun effects of price fixing for competing products may be harmful to LDC's, unless import quantities are also guaranteed. Furthermore, there is no good reason for importers of competing

⁴ In fact, the North, through the GATT, has suspended its duties on tea and tropical hardwoods. This modest accomplishment seems to have been the major result of the GATT action program in its first 3 years.

products to accept the principle of such transfers to other rich countries unless it is simply incidental to a policy of reaching domestic self-sufficiency, a la EEC.

The commodity approach to capital transfers suffers from many disadvantages in terms of administrative difficulties, economic inefficiency, promotion of substitute production, and encouragement of over-production. Its advantages are (1) it disguises the income transfer, thus apparently easing the recipient's conscience and relieving the donor of the burden of aid administration, a seemingly inescapable adjunct of official aid transfers; (2) it seems, within limits, to be more acceptable to importing countries than free trade in commodities, perhaps because the system is analogous to domestic commodity support programs. For these reasons, it seems likely that international discussion of policies for tropical exports will continue to revolve around price-fixing schemes. However, the increasing interest in supplementary finance (payments to underdeveloped countries whose export earnings over a period of time fail to meet reasonable expectations, because of circumstances beyond their own control—such as a long-term decline in world commodity prices, for example), arising from the United Nations experts' report and the UNCTAD resolution on the subject, may presage a gradual turning away from a single commodity approach.

PRICE STABILITY

The issue of price and earnings stabilization has become thoroughly confused with that of income transfer. Price stability and earnings stability are not the same for the individual exporter even if aggregate demand remains constant. If Colombian coffee output rises or falls 20 percent, constant world prices destabilize earnings. Stable earnings are sometimes asserted to be the goal, but it is not worth much to either importer or exporter simply to reduce short-term fluctuations around a trend by borrowing now and paying back later. The South wants to have greater price certainty but is not willing to reduce its freedom of action substantially in exchange for those benefits. It seeks much more strenuously to avoid low prices for products in inelastic demand, but that is not a question of stability.

If the objective were price stability, it would be possible to do something toward this goal by better price forecasting, use of buffer stocks, export controls, or price compensation schemes. The case for price stability is stronger than that for earnings stability because the prices of many commodities fluctuate so widely that they offer a poor set of signals for investment planning. They may also lead buyers to seek substitutes with more stable price levels. Providing that the system chosen to stabilize prices is a reasonably good forecaster of the market, it should help promote more rational investment. The extent to which this is desirable—and therefore also the price worth paying for it—depends on relevant opportunity costs. The amount of these costs is not an appropriate subject for aggregative analysis; and the detailed research that could offer some guidelines remains, as yet, largely prospective. The inference from existing work is that price stability isn't worth much as a guide to investment in terms of effects on GNP growth. However, we are still far from a definitive judgment on this subject.

CONCLUSIONS

The dominant conclusion that emerges from investigating all these aspects of international commodity trends and policies is that the South as a whole must look primarily to Northern prosperity as a source of export growth, and not to the UNCTAD policies. Should the effects of these policies be substantial, they are unlikely to be adopted; measures that are likely to be adopted are also likely to be unimportant as sources of increased capital or trade. Policies to increase or stabilize commodity earnings cannot proceed much faster than Northern willingness to act on the broader problem of LDC growth. This forecast offers scant encouragement to those who seek to promote Southern prosperity. But the issue here is prediction, not preference; and I find only faint grounds for Southern optimism about the course of international commodity policy in the decade ahead.

III. TRADE IN MANUFACTURES

The predominant economic element in the South's desire to industrialize as a means of becoming prosperous stems from differences in the income elasticities of demand for manufactures and commodities. World output of manufactures grew at the rate of 4.2 percent annually from 1937 to 1957 and at 8 percent annually from 1958 to 1964. Output of commodities, including petroleum, grew less than half as fast. The world economy has changed, therefore, and the South seeks to change with it. Domestic industrialization normally affects world trade in two ways: It increases the demand for manufactured imports in the industrializing countries and it leads eventually to the development of manufactured exports by countries that formerly exported only commodities.⁵

At UNCTAD, the South produced a formula and a rationale for increased trade and aid, in which industrialization was perhaps the most important element. The formula consisted of six principal elements: (1) higher prices for commodities; (2) greater trade access in Northern markets; (3) payments by the North to developing countries whose export earnings are persistently below some reference level; (4) preferential treatment in Northern markets for southern manufactured products; (5) creation of preferential regional trading systems in the South; (6) creation of a permanent UNCTAD as the forum for LDC trade and aid demands. This chapter deals primarily with trade access and trade preferences for manufactured products.

Both the Secretary-General's report, *Towards a New Trade Policy for Development*, and the Final Act of UNCTAD stressed that industrialization is the key to economic development and that increases in manufactured exports could act as the catalyst promoting that industrialization. In the words of the Final Act:

The Conference recognizes the urgent need for the diversification and expansion of the export trade of developing in manufactures and semimanufactures as a means of accelerating their economic development and raising their standards of living. It considers that individual and joint action by developed and developing countries is necessary to enable the latter to obtain increased participation,

⁵ A. Maizels, "Industrial Growth and World Trade," Cambridge University Press, 1963, ch. 1.

commensurate with the needs of their development, in the growth of international trade in manufactured and semimanufactured products.⁶

This view that industry is the key is commonly expressed by LDC spokesmen. The novelty in the UNCTAD approach lies in the assertion that industrial development can be fostered by export of manufactures, before a broad industrial base exists. Normally, the export of manufactured products on a large scale follows the long-term build-up of domestic industry.⁷

The South is making rapid strides in industrial development. From 1950 to 1962, its manufacturing output increased by nearly 8 percent a year; at the end of the period, volume of industrial production was 120 percent greater than in 1950. During the same period Northern industrial output grew by 80 percent. The powerful desire to industrialize quickly stems both from the close relation between industrialization and economic development cited above and from the foreign exchange problem that dominated discussions at UNCTAD. During the period 1955-63, value of world exports of manufactures increased at the rate of 8.1 percent annually, compared with a rate of 3.1 percent for commodities. Countries seeking rapid increases in export earnings are therefore naturally enticed by the prospects of trade in manufactured goods. Furthermore, Southern trade in manufactured products (excluding processed foods and refined metals), although still very small, grew at the rapid rate of 7.4 percent annually for the 8-year period. The contrast with the relative stagnation in commodity trade is not lost in the South.

Table 4 gives a regional summary of LDC exports of manufactured products for the years 1955, 1959, and 1963-64. Asia is by far the most important exporter, accounting for half of the total, and is also increasing its manufactured exports faster than other areas, thanks largely to the Hong Kong trade.

TABLE 4.—GROWTH OF WORLD EXPORTS OF MANUFACTURED GOODS, ^a BY REGION, 1955-64

[Dollar amounts in billions]

Region	1955	1959	1963	1964	Percent increase, 1955-64
World.....	45.5	61.1	86.3	98.7	117
Industrial countries.....	37.8	49.9	70.2	80.8	114
Eastern Europe.....	4.4	7.2	10.3	11.5	161
LDC's.....	3.0	3.2	4.8	5.5	83
Latin America.....	0.7	0.7	1.0	1.1	57
Middle East.....	0.1	0.2	1.8	1.8	100
Africa.....	0.8	0.9	2.4	2.7	108
Asia.....	1.3	1.5			

^a Includes refined metals.

Source: UNCTAD, Handbook of International Trade Statistics, Doc. E/Conf. 46/12/Add. 1, February 28, 1964; United Nations, Monthly Bulletin of Statistics, various years.

Several points emerge from the study of the manufactured exports of LDC's.

⁶ Final Act, par. 62, reprinted UNCTAD, Proceedings, vol. 1, p. 13. There was also a special principle favoring trade preference for the South in the draft Final Act, but it was not voted on.

⁷ The exceptions are of two kinds: (a) Materials-oriented industries, of which minerals refining (Chile, Mexico), pressing vegetable oils (Nigeria, Senegal), and refining sugar (Taiwan) or petroleum (Iran) are typical; and (b) industries that benefit from low-cost labor, notably textiles and certain other light manufactures (Hong Kong, India, Mexico).

1. LDC exports of manufactures are small compared with both total LDC exports (about 10 percent) and with world exports of manufactures (about 4 percent). On the other hand, the South buys nearly one-fourth of the manufactured products entering world trade.

2. This Southern export trade is very specialized. The handful of developing countries that export manufactures in quantity have so far concentrated either on light manufactures with a high labor content (carpets, textiles, footwear, clothing) or on processing local raw materials, with a rather small value added by manufacture (metals, plywood, jute products). The degree of this concentration is great by country, region, and product: nearly half of LDC manufactured exports come from two countries; one-third of LDC manufactured exports are textiles; two-thirds of all LDC manufactured exports are from Asia.

3. The export concentration is matched by import concentration. The United States and the United Kingdom account for nearly half of all Northern imports of manufactured products; both countries take more than 10 percent of their manufactured imports (including metals) from the South.

4. The rapid growth of world trade in manufactured products shows no signs of slowing down; this tends to reinforce the preference of the foreign exchange-starved South for industrialization as the high road to development.

This sounds obvious and innocuous enough. But on consideration, it turns out to imply some intractable problems. The fact that the South is a large importer and a small exporter of manufactured products means that it has a comparative disadvantage, or that money costs do not reflect real costs (as, for example, where industrial wages are maintained at higher levels than required to call forth a given labor supply).

Almost all underdeveloped countries will have to change their economic structures and, often, their economic policies before they can export these products. The North does tend to erect high tariff barriers against labor-intensive manufactures as demonstrated below. The effect is to discriminate somewhat against LDC's. In terms of today's realities, that discrimination is confined to the semiindustrial countries; and elsewhere, to the rather limited prospects for materials processing and refining.

Therefore, the UNCTAD contention that preferential access (and to a lesser extent, nonpreferential reduction of Northern trade barriers) will be the catalyst for industrial development implies one or more of the following beliefs: (1) Northern protection is so high that tariff preferences will allow today's inefficient industry to compete; (2) access to the vast Northern market will encourage new domestic and foreign investment on a scale that will permit preference-aided Southern industries to reduce costs through economies of production by large scale firms; (3) preferences will encourage those more widely diffused economies, arising from the growth of industries in general, that ultimately transform economic and social structures; (4) the preferential system will benefit only the semiindustrial countries directly, but the repercussions will ultimately influence the most backward countries, by increasing world demand for their commodities, by concentrating the flow of foreign aid toward them, or by a gradual

shift of labor-intensive industries toward the countries that are today least developed.

Each of these points can also be used to justify the demand for non-preferential reduction of Northern trade barriers, although the advantages to the South would be diluted. Let us start our discussion of policy choices by looking at these issues in terms of reductions of trade barriers and going from there to see how preferential systems might alter the results.

NONDISCRIMINATORY REDUCTIONS OF TARIFFS AND OTHER TRADE BARRIERS

Since the end of World War II, reduction of barriers to trade—tariffs, quantitative restrictions, exchange controls—has been a significant causal factor in the rapid growth of Northern trade. As yet, it has not shown the same catalytic effects on the South, despite the fact that under the GATT procedures the benefits of reductions have generally been available to all nations. The major reason is that the South exports commodities, raw or processed, for which effective trade liberalization has been much more modest. Another reason, of less immediate importance, is that the North has often failed to reduce its tariff on the labor-intensive manufactures for which the South presumably has a longrun comparative advantage.

In the domain of processed products and manufactured goods, Southern exports have grown more rapidly—at the rate of 5 percent annually from 1953 to 1963, and at nearly twice that rate in recent years (1958–64). It is not clear how much of this recent advance is attributable to cost reduction or to increases in demand induced by income growth and by tariff reduction abroad and how much to improved statistics; all statistics about underdeveloped countries are legitimate objects of suspicion. If Prebisch is correct in asserting that easy lines of import-substitution have been exhausted in many LDC's, then increases in export supply of these products may be a dominant reason. The argument for dominance of supply factors is reinforced by the fact that Northern incomes have not risen faster since 1958 than they did before, nor have tariff reductions proceeded faster.

The GATT negotiations for general tariff reductions that began in 1963 under the title of the Kennedy Round were aimed partly at counteracting the discrimination against outside suppliers created by the two European trade blocs, particularly EEC.

However, some Northern governments also claimed that the Kennedy Round, if it achieved its goal of a 50-percent reduction in Northern tariffs without requiring reciprocity from the South, would also greatly benefit Southern exports. Thus, in the words of the U.S. delegate to UNCTAD:

The industrial countries have done much in recent years to reduce these barriers. More can be achieved by deep, across-the-board tariff cuts in the "Kennedy Round"—and we are prepared to have these benefits accorded to the developing countries without asking reciprocity. Such tariff cuts can be of immediate help to the developing countries. But even more important they can provide an environment that will make it possible for them to build productive export industries. It is at this point that UNCTAD and the GATT Conference, which is to follow, so strongly complement each other.⁸

⁸ UNCTAD, *Proceedings*, vol. II, p. 396. Statement of George Ball, U.S. delegate.

Such viewpoints as this find their rationale in the case for free trade. The merits of free trade as a vent for surplus, source of new methods, and incentive to economic efficiency have been opposed by the protectionist rejoinder, based on infant industry and infant economy arguments, as well as on skepticism about the North's interest in actually allowing "low wage" manufactures to enter its markets. What are the facts? Will nondiscriminatory removal of trade restrictions have a great effect, a small one, or none at all on the growth of Southern trade and income?

First, what would be the result of northern adoption of "free trade" removal of all restrictions on trade in manufactured products? There are two kinds of short-run effects to consider: (1) substitution effects resulting from replacement of domestic products by imports, and (2) income effects resulting from the growth of world income as a consequence of free trade. The income effects, it can be confidently predicted, would be negligible.

The substitution effects would be far greater. It is impossible to estimate anything more than orders of magnitude, because we know so little about cost levels or about price elasticities of demand and supply. Johnson has made a valiant effort to estimate the effects, and emerged with a minimum figure of a 40-percent increase in LDC manufactured exports, resulting from abolition of Northern duties on manufactures.⁹ In 1963, this would have amounted to \$800 million if only manufactured articles are included, or to about \$1.3 billion if other processed products are included.

Johnson's estimate of a 40-percent increase is, as he recognizes, very conservative. It assumes that imports from LDC's would increase at the same rate as imports from the world. But both nominal and effective protection of manufactured products that LDC's are likely to export is greater than that on manufactured goods in general.

It has been long recognized that effective rates of protection are often higher than the nominal tariff rates imply. If copper ore, for example, bears no import duty, and refined copper is dutiable at 10 percent, then the effective protection is much higher than the duty implies. If ore accounts for 75 percent of the costs of refined copper production, then a domestic manufacturer of refined copper who purchases domestic or imported ore benefits from a 10-percent duty on the full value of output, not just on the 25 percent of its total value that the manufacturing cost represents. Thus, the height of the tariff on value added is not 10 percent, but 40 percent (10 percent tariff on total value, divided by 25 percent value added by manufacture). This means that the copper exporting nations seeking to build up a refining industry for export effectively faces a 40 percent tariff barrier in the importing country. The difference between nominal and effective tariff rates results from the fact that some goods are imported, not for immediate consumption, but as inputs into production. Normally, calculations of effective tariffs show that nominal tariff rates understate the real degree of protection, because tariffs on raw materials are usually lower than those on finished products.

Industrial countries' effective protection for all goods combined is roughly double the nominal rate for all products combined. It is gen-

⁹ Harry Johnson, "Economic Policies Toward Less-Developed Countries," Washington, D.C., The Brookings Institution, 1966, ch. 3.

erally highest on consumer goods, and is significantly higher in Japan and the United Kingdom than elsewhere in the North.

Effective protection is not only greater than nominal; it is also particularly high on manufactured products of interest to developing countries.

The effects of free trade are not only static, as discussed above, but also dynamic, leading to changes in economic growth and structures. The dynamic consequences of free trade might include changes in the location of investment leading to development of new skills and of product lines that, with the assurance of export markets, can operate at low unit cost; and the association of this cost-reducing pattern with growth of supply and demand in the pattern of increasing returns. These consequences of free access to Northern markets are more important than static effects, particularly if reciprocal tariff concessions are not required from the South.

It is impossible to estimate the extent of these dynamic effects, except by historical examples; these are always open to the objection that they reflect special circumstances. In recent years Puerto Rico and Hong Kong, by selling manufactures largely into zero-tariff or low-tariff areas, have experienced a vast growth of industrial output which has fed upon itself, bringing rapid improvement in living standards, providing capital and skills for new investments, and improving the relative cost position of the economy. In essence these cases seem to validate the classical economists' case for free trade as an agent of growth.

But both territories benefited from special circumstances: preferential access to U.S. markets and tax advantages for foreign investors in the case of Puerto Rico; and Commonwealth preference, plentiful local capital, and a huge, low-cost, adaptable labor supply in Hong Kong. The dynamic gains from free trade are much less striking in other Southern countries that have benefited from preference—notably France's former colonies and British Commonwealth members. In the French case, industrial exports, except for metals, are nil. In the British Commonwealth, the textile exports of India, Pakistan, and Honk Kong have been the principal beneficiaries of preferences for manufactures. As a general proposition, each case is *sui generis*, so the conclusions must remain agnostic. Some beneficiaries of Commonwealth preference seem to have grown no faster than the South as a whole. Trade liberalization seems to be a necessary condition of industrialization only for small nations and is never a sufficient condition of itself.

The GATT aim of reducing tariffs on manufactured goods without requiring reciprocity from the South, nevertheless, remains a goal worth striving for, by the criterion of Southern self-interest. Any such reductions are overwhelmingly likely to benefit the South rather than hurt it; the only practical qualification arises from the operation of preferential systems, as discussed below. If tariffs are reduced on labor-intensive manufactures, LDC exports of such products are likely to rise dramatically.

But the race is generally to the swift, at least in the short run; and liberalization, to the extent that it does materialize, will obviously most favor countries that are initially prepared to export. This means above all the North; and next, Hong Kong, India, Israel, Mexico,

Philippines, Pakistan, Taiwan, Argentina, and Brazil, perhaps roughly in the order of their current exports. For most of the rest of the South, there is little or no short-run capacity to supply the world market for manufactured products. The advantages, for their trade and industrial development, of a nondiscriminatory system of one-way tariff cuts for manufacturers are long run, except where tariff reductions facilitate simple raw material processing.

PREFERENTIAL SYSTEMS

The South, in the name of economic justice, seeks preferential treatment, not free trade. The call for preferences is the clarion of UNCTAD's own Great Society and must be understood, as any such rallying cry, less for its content than for the aspirations it embodies. Prebisch's economic theories and policy proposals are the rationalizations for a profound sense of injustice. Therefore, the economics of preferences are only a minor aspect. Nonetheless, we will begin our discussion of the subject with a review of the economic issues.

There are two kinds of preferential systems for manufactured products in effect today: (1) customs unions and free trade areas, which, in principle, offer duty-free entry to members only on all products (EEC, EFTA) and (2) preferences for all or some products, offered by rich countries to poor ones on a reciprocal or nonreciprocal basis (EEC preferences to associated overseas states, U.S. free trade with Puerto Rico and preferences to the Philippines; Commonwealth preference offered by the United Kingdom). The two are similar in many respects. In this study, I will deal only with the second, particularly with its world wide application.

A preference system in its simplest form allows free entry to the exports of the preference-receiving countries in the markets of preference-granting countries, while the exports of countries not receiving preferences continue to be dutiable. The principle proposed, but not voted on, at UNCTAD in 1964 would have been such a one-way preference. The South would receive preferences in Northern markets, but not grant them to the North in return. An infinite number of variations of one-way discriminatory free trade is possible and we will discuss some of them, after examining the basic theme.

The arguments for a worldwide system of preferences from north to South are all based on the judgment that it is desirable or expedient for the North to promote the industrialization of the South; or, from other motives, at least to give the impression of promoting it. The economic case is based on the belief, reinforced by the effective tariff argument, that preferential treatment will hasten industrialization by offering the LDC's the near equivalent of a protected infant-industry market in the North, as well as the possibility of economies of scale in production, arising from the size of that market. Underlying that belief is the tacit assumption that income elasticities of demand virtually dictate industrialization as the route to prosperity and trade growth. Given these beliefs, the principal arguments favoring preferences are as follows: (1) the future gains accruing to the South from further trade liberalization are uncertain, both because of doubts surrounding the results for the South of the GATT negotiations concluded in June 1967 in light of exemption lists, which drop many

products of interest to the South from the tariff-cutting procedure; (2) even if those gains were forthcoming and large, infant-industry and equity grounds conspire to warrant further concessions to the South; (3) the income transfer involved in making price concessions to the South is small but is more acceptable politically to donor and recipient than the equivalent foreign aid subsidy; (4) many LDC's have gone as far as—and often farther than—they should in import substitution, so that any device to encourage export-promotion is desirable; (5) the South wants preferences, and the North's costs would be negligible, whether or not the alleged gains materialize.

The arguments against preferences are: (1) they tend to promote and perpetuate economic inefficiency—even the valid infant-industry and scale-economy arguments are grounds for subsidy rather than preference; (2) rather than improving North-South relations, preferential systems would exacerbate them for a variety of reasons—they inevitably discriminate in effect against some LDC's and some Atlantic countries, they would create an automatic obstacle toward further efforts to liberalize world trade (because reduction of tariffs also reduces the preference margin), and they would, if successful, create a type of economic dependence on northern concessions that is inconsistent with the South's struggle for independence; (3) preferential systems are strikingly complicated to administer in any event, and impossible to manage without inequity to some parties; (4) preferences are likely to bring with them the reverse of the effects intended, because the introduction of preferences gives Northern producer interests a chance to legislate restrictive "safeguards," that would be impossible under a nondiscriminatory tariff policy (known technically as "most-favored-nation" or MFN system); (5) the gains from preferential systems would be small, because tariffs, even effective tariffs, are generally low now in light of the South's cost disadvantage, and would be still lower after GATT negotiations are completed; (6) preferences are an inferior way to give aid and lead to an inequitable distribution of aid costs.

It must be obvious by now that the differences in assumptions, goals, and estimates of the fact are so great that there can be no final answer. I favor extension of preferences to the South, whether or not on a worldwide basis, providing they are temporary with fixed expiration dates (preferably set by reduction of MFN tariffs to the preferential rate), or, failing that, are limited by quota or other device. My reasons for supporting preferences are based on the beliefs that the North should do more than it now is to help improve Southern living standards, and that preferences will make some contribution in that direction. They would create both administrative problems and incentives to inefficiency but would also provide positive incentives to domestic and foreign investment that could make a big difference to the rate of economic and social development of some countries. The stress on efficiency overlooks material issues: (a) short-run efficiency and long-run growth are not necessarily achieved by the same methods; (b) there may be a conflict between efficiency and equity; (c) preference-induced increases in Northern investment abroad will strengthen the Southern lobby in the North, and may therefore be a risk worth taking, at least for those who generally support Southern claims. In practice, the best way to reconcile the conflicts between the gains and

losses from preferences is to tie the adoption of temporary preferences into a general system of progressive reduction of MFN tariff rates, as discussed below.

SOME PROPOSALS FOR PREFERENTIAL SYSTEMS

The French Plan.—The Brasseur plan, as advanced by France in 1963, provides for negotiations of separate bilateral agreements in a system of selective, temporary, and decreasing preferences. Each preference-granting country decides in each case to whom it will accord preferences, for what products, with what tariff quotas, with what preference margin, and with what duration.

The application of this system by 20 northern countries to 70 LDC's for 1,000 products would require the equivalent of 1½ million bilateral negotiations. Furthermore, each preference-granting country would not operate in a vacuum. Its decisions about each bilateral preferential offer would be made in light of the decisions made by other Northern countries, so that de facto multilateral negotiations would be superimposed on the system. These are virtually certain to be crippling obstacles to a large-scale system. The French Government has tacitly recognized the defects and its current proposals for preferences no longer stress the merits of the Brasseur plan.

The French system, however, offers some decided advantages in theory. It assures one or a few preference-receiving countries of exclusive preference. Therefore, domestic or foreign investors in the preference-receiving country are able to rely on a relatively sure export market, once they are able to meet the preference-granting country's domestic price for the product. Worldwide extension of preference offers no such guarantee. A second advantage, for governments, of the French system is its flexibility. Internationally, it can be used as a device to help friends or punish the recalcitrant; at home, it can be used to protect domestic industries, or to threaten those who fail to agree to government price, investments, or employment guidelines. Finally, in theory, it is the most equitable system, in terms of equalizing benefits received, because it allows the preferences to be adapted to provide for the circumstances of each country. In practice, of course, the political pressures for foreign and domestic interests would prevent the attainment of such a goal, even if the preference-granting country were inclined to aim at it. LDC's have shown little enthusiasm for the Brasseur plan, because of its complexity and the evident colonialist connotations.

The LDC Plan.—The administrative headaches are by no means dispelled if the South's most recent proposals are accepted instead. At UNCTAD meetings in 1965, the LDC's asked for general one-way preference, with larger margins for the least-developed countries than for those that are already semi-industrial. This plea for equity requires the very difficult determination of which preference category each LDC falls into. The LDC proposal also specifies a quota-free preference, with no products exempted. This is a blow in favor of administrative simplicity, but if insisted upon as a condition, it would foreclose the possibility of general preferences. The prospects for Northern acceptance of a system that allows unlimited preferential access to all comers can best be judged by reference to the recent history of textile imports on MFN basis.

Furthermore, the graduation of preference margins is a plea for equity in Southern eyes, although its short-term effectiveness in promoting, for example, African exports of manufactures may be doubted. But it implies an inequity in the North. High-tariff countries in the North would bear a greater adjustment burden than low-tariff countries. Equity in this sense requires equal tariff reductions among preference-granting countries.

But in practice, this kind of "damage-limiting" equality can be achieved only by setting preferential rate import quotas by product and, thereby, creating considerable administrative problems. If, as has been suggested in the name of equity, portions of each product quota were assigned to each LDC, effective administration would become a real challenge.¹⁰ Furthermore, if, as Johnson proposes, exporters' quotas were made negotiable to allow nonexporting LDC's to sell their rights to those that can benefit from the preference, the claim to equity would be increased at the expense of still greater administrative novelty.

One-way Free Trade.—The optimum system, to combine ease of administration, Northern political imperatives, and genuine impact on development, requires: (1) quota-free preferences; (2) a list of excepted products—those that now compete effectively in the North; (3) an escape clause that allows tariffs to be reimposed if imports exceed some stated proportion of domestic demand; (4) and, most important politically, establishment of general preferences as a step on the road to a worldwide MFN system.

This system, like most income-redistributing policies, is rife with inequity. It also leaves unanswered such knotty questions as which countries should be eligible for preferences, what the escape clause criteria should be, and whether the preference should be permanent or temporary, worldwide, or selective. But it has the sovereign advantage of being workable, and of encouraging the industrial development of those countries that are actually ready to industrialize.

It is generally believed that preferences should be temporary to avoid setting up a permanent vested interest in discrimination. Prebisch has suggested that no LDC be allowed to benefit from preferences for a specific product for more than 10 or 15 years, for example. This device would allow new producers to enter the market over time and submit established LDC producers to the test of world competition. However, this approach introduces substantial complexity because of the large numbers of countries and products. Furthermore, established LDC suppliers will be reluctant to surrender their "temporary" preferential advantages. They may well band together under the banner of "*la justice exige que seul le provisoire dure.*"

The politics of the situation therefore dictate a somewhat different approach. If preferences are to be temporary, they should be established on the principle of according advance reductions to LDC's in a general program of worldwide MFN reductions. For example, if the North accords LDC's a 50 percent tariff reduction on manufactured products for 10 years, the preference would end not by raising the preferential rate back to the preexisting MFN rate, but by lowering the MFN rate to the preferential rate. This method presents dual

¹⁰ How to distribute country quotas to exporters offers no fewer difficulties than how to set the size of the quotas initially.

advantages. First, it increases the pressure on Northern countries to reduce their trade barriers. Failure to reduce their tariffs simply perpetuates LDC's competitive advantage. Second, and for similar reasons, it reduces the ability of LDC's to perpetuate the preferential margin.

If preferences are integrated into a system of staged MFN reductions in this manner, no major recasting of the existing trade system would be required (although GATT rules would have to be amended). Furthermore, it even offers some prospect of mutual advantage. Countries that seek liberal trade can then look upon preferences as a way station toward that goal. Countries that seek to help LDC's can harness free trade efforts to their wagon.

On the other hand, a system of this kind is likely to meet opposition on several counts: from countries that are not interested in general tariff reductions, from LDC's seeking perpetual preference, and particularly from LDC's that are still at very early stages of development. The latter group might fear that progressive MFN reductions would in fact leave them with no significant preference margin by the time they were ready to export manufactured products.

No system of preference administration can avoid the problems raised by the fact that some people will be hurt more than others and some helped more than others. But the remedy for this does not lie along the lines sought by France and the LDC's. It requires instead adjustment assistance for Northern firms that suffer damage and shifts in the distribution of foreign aid for those LDC's that fail to benefit.

THE EFFECTS OF PREFERENCES

The attack and defense of preferences seems to become more intense as our ignorance of its effects becomes more apparent. Instead of responding by trying to clarify the facts about trade, development, and industrialization, policymakers all too often seem to take ideological refuge in one or another version of whatever theory happens to be congenial.

Unfortunately, we know rather little about the effects of preferences. Sometimes, when other incentives or prerequisites were present, they have apparently had a marked effect on trade (Puerto Rico). In other cases, the results have not been striking.

Commonwealth Preference.—Only one preferential system, that of the British Commonwealth, has been studied in detail.¹¹ The studies review the effects of preferences from the time they were introduced (1932) until 1962. During that period, United Kingdom imports from the Commonwealth increased relatively by nearly one-third, accounting for 30 percent of all British imports by value before preferences were introduced and rising to an average of 40 percent during the period 1960-64. During the early postwar period this increase was even more marked, but both GATT tariff cuts and the easing of the dollar shortage have had their effects. In the period 1959-65, for example, Commonwealth imports fell from 44 percent to 36 percent of the United Kingdom import total.

The preference is highest for manufactures, averaging about 20 percent, ad valorem, in 1962, compared with an average of 11.8 percent

¹¹ Political and Economic Planning, "Commonwealth Preference in the United Kingdom," London, 1961; R. W. Green, "Commonwealth Preference," Board of Trade Journal, June 11, 1965, pp. iv-xix, and Dec. 31, 1965, pp. 1551-58.

for all imports enjoying preferences in that year. If nondutiable imports are included, the figure is much lower, because most foodstuffs and raw materials are duty-free from any source. The average duty on Commonwealth imports has fluctuated considerably over the years.

The areas that export manufactured products to the United Kingdom therefore benefit from higher margins than the 7.2 percent Commonwealth-wide average.

Manufactured products accounted for 9 percent of United Kingdom imports from the Commonwealth in 1957, 14.5 percent in 1962, and 16 percent by 1964. The principal beneficiaries in respect to manufactured imports were Hong Kong, India, and Pakistan, benefiting respectively in 1962 from average preference margins of 19, 11, and 14 percent.

The pattern of United Kingdom trade was significantly affected by the preferential system. The United Kingdom took 14 percent of its total imports of manufactured products from LDC's in 1964, a higher proportion than any other industrial country. Three-fourths of this amount came from preferential suppliers.

Although the effects were significant, they were hardly revolutionary. The principal factors in mitigating preferential effects were: the gradual erosion of preferential margins resulting from MFN tariff reductions; the United Kingdom had a comparative advantage in manufactures and received reciprocal preferences in Commonwealth markets in some cases; Asian members best able by virtue of economic structure to profit from preferences were remote from the United Kingdom, so that transport costs and unfamiliarity of the market may have loomed large; after independence, these countries generally turned to import-substitution as the easiest form of industrialization.

There is no evidence that Commonwealth countries, or other preference-receiving LDC's, have had a more rapid growth of manufactured exports than nonpreferred suppliers. In fact for the period 1960-65, for a group of 65 LDC's including all the major exporters, manufactured exports of those not receiving preferences increased by 100 percent, while those of preference-receiving nations rose by only 67 percent. Part of this difference reflects a statistical factor. Hong Kong, India, Pakistan, and the Philippines, all receiving preferences, accounted for half of the 65 countries' manufactured exports. All preference-receiving LDC's combined accounted for two-thirds of the South's manufactured exports in 1964. Therefore, the more rapid relative growth of exports to the North from nonpreferred suppliers largely reflects the fact that they started from a small base, about \$320 million in 1960, compared with \$914 million in that year for preference-receiving countries. These data for the 1960-64 period illustrate both the gains from preferences and their limitations. The grant of preferences undoubtedly makes some contribution to the dominant role of preference-receiving nations in world markets for LDC manufactures. But the data also illustrate that preferences are not essential to the development of LDC trade in manufactured products, as witness the very rapid growth of exports from Mexico, Israel, Taiwan, and South Korea since 1960.

The results of Commonwealth preferences offer an example of the primacy of preconception over analysis in these matters. The preference system demonstrated modest but helpful effects for the benefi-

aries. These presumably would have been greater if the preferential market was larger and less remote, and the exporting nations' independence longer established. The steady growth of United Kingdom-manufactured imports from the preferential area since 1957 supports this latter opinion. Yet much contemporary public discussion ignores this, by stating either that the results would be negligible for the South or difficult for the North.

BALANCE-OF-PAYMENTS EFFECTS

A second point at which the scanty observed results differ from the evidence is in the estimate of what preferences would do to balance of payments. It is claimed that the United States cannot given preferences because they would lead to increased imports, thereby worsening the balance of payments. The problem is analytically quite complex, because increases in U.S. imports from LDC's have a series of effects on the balance of payments.

If the new imports from LDC's substitute for goods previously imported from the North, then the balance-of-payments results will depend on the relative extent to which North and South spend additional foreign exchange earnings in the United States. Obviously, if Northern countries use dollar earnings to build up reserves, while LDC's use them to finance imports, then a switch in the source of supply from North to South benefits the U.S. balance of payments. But the full effects depend not only on the initial disposition of the dollars earned by foreigners, but also on subsequent rounds of spending.

Some research has been carried out in order to measure the balance-of-payments effects of tied aid compared with untied aid. This research indicates that there are sharp differences among LDC's in their marginal propensities to spend additional dollars, tied or untied, in the United States, but that these intercountry differences narrow when additional rounds of respending are taken into consideration.

Two points stand out: (1) during 1960-64, LDC's increased their imports from the United States one-third faster than the growth of LDC exports, while their imports from the rest of the North increased only half as fast as LDC exports; (2) although U.S. exports to the North increased at the same rate as to the South, these increases were smaller than either the rate of Northern trade growth or the growth of Northern exports to the United States.

These data offer some implication therefore, that diversion of U.S. imports from North to South results in an improvement of the U.S. trade balance. Naturally, these aggregative computations offer only an indication. The data for the 1960-64 period also reflect an accentuated U.S. emphasis on tied aid, as introduced under pressure of America's balance-of-payments concerns. For the period under review, this may have been a dominant element in the rapid growth of U.S. exports to LDC's.

Countries that face substantial trade diversion from preferences (such as Japan) are unlikely to recoup fully through these respending effects. But those whose exports are not highly competitive with potential LDC exports may well gain on balance. If, as seems likely, LDC's spend all their additional foreign exchange earnings, the effect for all

industrial countries, as a group, is neutral. The question at issue, however, is the country-by-country incidence of that effect. Some industrial countries would benefit, in balance-of-payments terms, while others would lose. The analysis that would help to answer the questions "who?" and "how much?" remains to be performed.

PREDICTING THE TRADE EFFECTS OF GENERAL PREFERENCES

Whatever the likely balance-of-payments effects, or the record of existing preferential systems, they give us no sure guide to the trade effects of the proposed general system. The estimates that have been made so far are not very helpful, because they are based on static analysis, and are defective, even in those terms, because of our ignorance of the relevant supply and demand elasticities. However, they serve some purpose in indicating whether short-run effects are large or small.

One such estimate has been made by Grant L. Reuber.¹² He has made various assumptions about trade effects for LDC's of: (1) reducing MFN tariffs to zero; (2) reducing MFN rates only enough to maintain existing preference margins; (3) maintaining MFN rates for the north and reducing LDC rates to zero. Not surprisingly, he concludes that the South would benefit most from the last alternative. With an average tariff of 12 percent and a demand elasticity of minus 2, he estimates that LDC exports of manufactured products subject to significant tariffs, but not now subject to quantitative controls, would increase by 25 percent (or \$250 million), and exports of noncompeting unmanufactured products by 2.4 percent (or \$350 million), for a total effect, at 1961 trade levels, of \$600 million. If quantitative restrictions were removed from competing goods, he estimates an additional \$1.1 billion of imports would result under "optimistic" assumptions. Reuber points out that these effects are negligible compared with current levels of trade and aid.

Johnson has said that Reuber's is too low an estimate because it neglects effective protection. He offers an estimate for increases in manufactured exports alone under free trade of \$600 million. Preferential trade results would be correspondingly greater. But if a figure of \$600 million is used to adjust Reuber's estimates, the short-run trade effect of preferences becomes about \$1 billion, even if existing quantitative restrictions are retained.

As an alternative to this approach, I have estimated the effects on a different set of assumptions, and emerged with a result that is not significantly different. My method was to assume that the developed countries would allow a preferential duty-free tariff quota to the South on a product-by-product basis. There were three additional assumptions: (1) Preferences would not be extended products for which the South is now competitive; (2) tariff quotas would not be effective in stimulating imports of manufactured products either when existing tariffs are below 5 percent ad valorem, or when, no matter what the tariff level, technology and scale problems seem insurmountable; (3) preferential quotas would be set at 5 percent of last year's imports of all products. Using 1962 data for Western Europe, Japan,

¹² "Canada's Interest in the Trade Problems of the Less-Developed Countries," Private Planning Association of Canada, Montreal, 1964, pp. 23-29.

Canada, and the United States, this exercise produced the following results:

I. Manufactured products with average tariff below 5 percent

A. 1962 Northern imports from—All sources, \$4.1 billion; LDC's, \$30 million.

B. Potential preferential imports under 5 percent tariff quota,^a \$175 million.

II. Manufactured products with average northern tariffs greater than 5 percent^b

A. 1962 Southern imports from—All sources, \$31.8 billion; LDC's, \$277 million.

B. Potential preferential imports under 5 percent tariff quota,^a \$1.3 billion.

At the May 1965 meeting of the UNCTAD special committee on preferences, the South asked for a preferential system that would allow duty-free entry under a global quota of 10 percent of all Northern imports. The effect if each of the Northern countries took 10 percent of their manufactured imports from the South compared with 1963 trade levels would be equivalent to \$5.1 billion. The total increase in imports under these assumptions would have been \$2.5 billion, because 1963 Northern imports from the South, including metals, were worth \$3.1 billion.¹³ If, on the other hand, we assume that the global duty-free quota would result in a 10-percent increase in imports, then the value of the trade increase would be \$5.2 billion, a sum far in excess of any current estimates. In practice, the entire range of aspirations represented by the \$2.5 billion "minimum" and the \$5.2 billion "maximum" lies above what can reasonably be expected from preferences in the short run.

Halting as these initial estimates are, they can be considered solid compared with estimates of the full effects, allowing for all the dynamic considerations discussed earlier. The best we can say now is that the evidence supports neither LDC hopes nor Atlantic countries' fears of "market disruption." Obviously, if under a 5-percent tariff quota, or similar limiting device, the initial (2 to 5 year) trade effect is of the order of \$1 to \$2 billion, the aggregate damage to Northern producers is negligible.

CONCLUSIONS

For many Southern countries, sharply increased production and exports of processed materials and manufactured goods are probably one condition of rapid economic growth. In some cases, the possibilities are fairly good under a liberal nondiscriminating trading system. Some countries would really not benefit much unless they could get preferred treatment. Others are now too underdeveloped to export manufactures (except refined ores and foodstuffs), even with preferences. They will need considerable time and assistance before they can look even to domestic industrial markets.

^a If all quotas are used by LDC's. Tariffs weighted by trade.

^b Excluding products for which LDC's are now major suppliers.

¹³ This increase of \$2.5 billion, added to the \$3.1 billion existing level, gives a total of \$5.6 billion, not \$5.1 billion. The discrepancy arises from the fact that the United States and the United Kingdom now take more than 10 percent of their manufactured imports from the South.

In theory, preferences in Northern markets benefit the South more than free trade, because they confer a price advantage over competitors. This advantage could be offset if the grant of preferences were tied to restrictions on entry. In any event, the benefits of preferential systems are likely to be important only to the semiindustrial countries in the short run. These short-run increases in LDC exports might be of the general order of \$1 billion annually under a system of one-way free trade, if existing quantitative restrictions are maintained.

In the long run, preferences should help shift world location of processing industries toward the raw material sources, encourage greater domestic and foreign investment in industry, and promote a greater awareness of trade opportunities. Not even the roughest guess of the size of these effects is possible.

The case for preferences is in large part political, because they involve, among other elements, a transfer of resources and adjustment costs to Northern producers. If the North wants to be associated with the South and influence its policies, encouragement of trade ties can have its uses, at modest cost. Conversely, the refusal to grant preferences, unless it is accompanied by some other form of aid, does nothing to reduce North-South tensions. This is an important consideration for the United States, which is still saddled with its somewhat negative UNCTAD record. Unfortunately, its stand on preferences remained unaltered, despite strong pressures from other OECD countries and LDC's at the 1966 meetings of the UNCTAD preferences committee. Ultimately, U.S. policy will be forced to change, as already foreshadowed by President Johnson's statement at Punta del Este in April 1967. However the prolonged delay probably benefits neither North nor South. The system proposed by other OECD countries was objectionable because it was based on tariff quotas, which are all too likely to be used as tokens of preferential treatment with little real effect. Nonetheless, the U.S. refusal to agree to any scheme can hardly be viewed as a constructive alternative.

It is one thing to affirm, as I have, that political and economic advantages could stem from preferences, and quite another to claim either that the benefits would be vast, or the pitfalls negligible. There is no evidence to support the view that the economic transformation of the South awaits only the infant industry effects of preferences. Nor can the view be dismissed that the use of preferences is likely to be either as an instrument of trade restriction, somewhat in the manner of U.S. sugar legislation, or as a token gesture that will arouse more resentment than support in the South. But new policies normally have their risks, and these are no different. In this case, the political risks seem more modest than the gains.

Finally, each underdeveloped country is a special case, and each will develop differently. Whether Northern policies are enlightened or not, some of today's poor nations will inevitably prosper, while others, by comparison, will seem to stagnate. In a century-long perspective there will be countries that will far surpass a tenfold growth of per capita income, and others that will not even be close. This in turn will raise new questions of international equity and perpetuate old ones. Arbitration of these discords will be the task of another era. The success of contemporary generations in attacking poverty will be measured by how much or how little its descendants need be concerned with the issues I have analyzed here.

IMPORTS OF MANUFACTURES FROM LESS DEVELOPED COUNTRIES

BY HAL B. LARY

The following analysis is condensed from a comprehensive study being prepared for publication by the National Bureau of Economic Research. The study is subject to revision in the light of comments by the board of directors of the National Bureau and other readers, and the present abridged version is submitted on the author's own responsibility. *July 1967.*

CHAPTER I. THE PROBLEM AND A SUMMARY OF FINDINGS

INTRODUCTION

It seems to be generally agreed that newly developing countries will need to achieve a rapid and sustained rise in export earnings to cover their growing imports of capital goods and other essentials and to service their foreign borrowings. Failure to attain such an increase, or to receive ever larger foreign aid, would impose a foreign exchange constraint on their growth, even though the major transformation required is in their internal economic and social structures and in their capacity to save and invest.

Looked at from this point of view, the figures in table I-1 are not reassuring with respect to the export performance of the less developed countries.¹ Over the period 1950 to 1965 these countries, exclusive of the major oil producers among them, increased the current dollar value of their exports to the developed countries by 4.2 percent annually on the average. Their exports to each other, again omitting the major oil producers, were only slightly larger in 1965 than in 1950. Over the same period the dollar value of trade among the developed countries rose at an average annual rate of about 9.4 percent, or perhaps a percentage point less if figured at constant prices. Total exports of developed countries to the destinations covered by table I-1 were about 2½ times those of the non-oil-producing less developed countries in 1950 and were five times as great in 1965.

The need for a faster increase in exports of the less developed countries will not be elaborated here, since it has been studied at length by the United Nations and others. One may question alternative projections of the likely "foreign exchange gap," or the validity of the gap approach. But there seems to be little room for doubt that exports of the less developed countries will need to rise faster than heretofore as one of the conditions for their economic development.

The contrasting performance of exports of developed and less developed countries reflects, in addition to factors on the supply side, the faster growth of world demand for manufactures than for most of

¹ Throughout this study the less developed countries are taken as comprising all of the Western Hemisphere except the United States and Canada; all of Africa except the Union of South Africa; the Middle East except Turkey; the rest of Asia and the Far East except Japan, mainland China, and North Korea; and Oceania except Australia and New Zealand.

TABLE I-1.—EXPORTS OF DEVELOPED AND LESS DEVELOPED COUNTRIES, 1950 AND 1965 ^a

	Value (billions of dollars at current prices)		Compound annual rate of growth, 1950-65 (percent)
	1950	1965	
World exports (total).....	53.5	156.3	7.4
Exports of developed countries (total).....	35.9	122.5	8.5
To each other.....	25.0	95.5	9.4
To less developed countries.....	10.9	27.0	6.2
Exports of less developed countries (total).....	17.6	33.8	4.5
To developed countries.....	12.4	26.2	5.2
To each other.....	5.2	7.6	2.5
Exports of less developed countries, excluding major petroleum producers ^b (total).....	14.1	23.7	3.6
To developed countries.....	10.0	18.5	4.2
To each other.....	4.1	5.2	1.7

^a All figures exclude exports to and exports of Eastern Europe, the U.S.S.R., and mainland China.

^b Countries excluded are Algeria, Iran, Kuwait, Libya, Netherlands Antilles, Saudi Arabia, Trinidad and Tobago, and Venezuela.

Note: Figures may not add to totals shown because of rounding.

Source: Various statistical publications of the United Nations.

the primary products which make up the bulk of the exports of the less developed countries. Reasons for the relative lag in trade in primary products include economies in their use, the continuing development of synthetic substitutes, and the growing complexity and sophistication of final products, all of which tend to reduce the input of raw materials per unit of output.

It will therefore be accepted as a starting point for the present analysis that the increase in exports of the less developed countries will have to be largely in manufactured goods. Some countries exceptionally well endowed with natural resources may be able to meet their growing foreign exchange needs through sales of primary products in crude or processed form. The oil-exporting countries form a small and privileged group in this regard. Broadly viewed, however, there is little reason to suppose that the influences tending to retard the growth of trade in primary products have run their course. If this is a correct judgment, a solution commensurate with the growth needs of the less developed countries will presumably entail a rapid increase in their exports of manufactures to the advanced countries.

LABOR-INTENSIVE MANUFACTURES

This study seeks to identify the kinds of manufactures best suited to the growth of exports and to examine the pattern and prospects of trade in these items. By definition, the less developed countries have little accumulated capital or technical skill. Any comparative advantage which they may hold or attain in manufacturing for export, apart from strongly resource-based industries, is therefore likely to be in industries which are intensive in the use of relatively unskilled labor and sparing in the use of both physical and human capital.

Such a course encounters obvious problems and resistances on the side of the developed countries. But it also offers them the possibility of shifting scarce manpower from traditional lines of production

to other industries where labor can be more productively combined with their capital resources.

Such a course may also be unwelcome to some of the less developed countries, implying concentration on relatively simple types of manufacturing and perhaps excessive exposure to the risks of international trade. These disadvantages are scarcely greater, however, than those entailed in their present heavy reliance on exports of primary products. And, if the analysis given here points in the right direction, a willingness to focus initially on labor-intensive lines of manufacturing may be a necessary condition for evolving toward the production of goods with, as Fei and Ranis say, "an increasing skill and ingenuity component over time."²

It may be further objected that, apart from qualifications such as that just given, the approach taken here makes no specific allowance for the possibility that comparative advantage may shift as development proceeds, thanks to internal and external economies of scale and other dynamic influences associated with growth. How much weight should be attached to this possibility in the present context is difficult to say.

One factual observation deriving from this study is that, if the argument is deemed to be relevant to, or consistent with, the need to increase export earnings of less developed countries, there is little indication that any of these countries have so far become competitive in the more capital-intensive lines of manufacturing (except, of course, those based on the exploitation of natural resources). Usually, however, dynamic considerations have not been related to problems of export promotion but have been invoked rather to favor a strategy of import substitution and may be subject to the same need of cautious reappraisal as that seen below.

Still another possible objection to the present approach is that, even within a comparative cost framework, the emphasis may be too much on labor intensity to the neglect of other conditions affecting the ability of less developed countries to sell manufactures in the markets of the more advanced countries. Some industries are more strongly market-oriented than others, and ease of communication between producer and customer may bear importantly on their location.

Even in such cases, the increasing speed of international communications and growing experience in procuring abroad may open up new possibilities of siting production where costs are lowest. This is illustrated by the evolution of the garment industry in Hong Kong toward high-fashion goods and also by the encouragement given by American companies to the production of electronic and other components in low-wage countries.

THE OVERSPILL VIEW OF EXPORTS

The usual approach to the problem of increasing exports of manufactures by the less developed countries has been along the lines of what Winston Churchill once called the overspill view of exports in Britain. That is, concentrate first on developing the home market, and this will create the conditions needed for an efficient and rising export trade.

² John C. H. Fei and Gustav Ranis, "Development of the Labor Surplus Economy." Homewood, Ill., 1964, p. 303.

W. W. Rostow has put the point in the following way, with more specific reference to the problems of the less developed countries: "What I am asserting, then, is that the expansion of the domestic market which is required to produce a modernization of rural life and an ample market for domestic industry is also the proper base for the development of diversified exports."³

A similar conception seems to infuse programs of financial assistance to the less developed countries. The International Bank's loans and feasibility studies have mainly focused on the infrastructure and the home markets of the less developed countries and have rarely served more directly to develop their exports. Our AID programs have also been chiefly concerned with strengthening the internal conditions for development, though some of the studies of investment opportunities which it has helped to finance point toward export possibilities. The Export-Import Bank has well merited the first half of its name by granting credits to finance sales of capital equipment and other goods to the less developed countries. But little of its financing has been aimed at stimulating imports from them.

The power and transportation facilities, machinery, and technology made available through these loans and grants do, of course, help to build up the economies of the less developed countries and may ultimately serve to diversify and strengthen their exports. Moreover, these public agencies no doubt consider, with some reason, that investment opportunities offering attractive export prospects are particularly suited to private initiative and financing and do not require public development aid.

It seems fair to observe that the advanced countries have accepted restrictive import policies by the less developed countries as a necessary accompaniment of industrial development, and also have so far made little adjustment in their own policies to facilitate the growth of imports of manufactures from the less developed countries.

Under these conditions, it is remarkable that this trade, at least in some products, has grown as fast as it has in recent years. The growth has, however, been very unevenly distributed by exporting as well as by importing countries—a fact that underlies the trade demands put forward with increasing vigor by the less developed countries during and since the United Nations Conference on Trade and Development (UNCTAD) in 1964. The need to find better ways of expanding their exports is evident. The means proposed to this end—on either side—are more debatable, sometimes seeming primarily designed to shift responsibility for action to other countries while avoiding commitments that might entail awkward adjustments on one's own part.

LIMITATIONS OF MARKET SIZE IN THE LESS DEVELOPED COUNTRIES

However persuasive the argument may seem, it rather begs the question to say, with Rostow, that the most effective base for the export of manufactures is a large domestic market. According to one estimate, only five of the less developed countries have national incomes (converted to dollars at prevailing rates of exchange) larger than Connecticut. These are India, Pakistan, Brazil, Mexico, and Argen-

³ W. W. Rostow, "Economic Development in Asia," Department of State Bulletin, May 31, 1965, p. 850.

tina, to which perhaps Indonesia (with poor statistics but a population of 100 million) should be added. Though the beginnings of industry go back rather far in some of these countries, none of them has yet done sufficiently well in exporting manufactures to vindicate the overspill view.

The six countries just mentioned account for more than half of the total population of the less developed countries, but that still leaves a host of people and problems outside as well as inside. Close to 100 of the less developed countries have a population smaller than 15 million, and in two-thirds of them it is less than 5 million.

On the whole very poor, they are smaller still in size of market compared with most developed countries. More such countries are being born as Malta, Gambia, the Mauritius Islands, and the few other remaining European possessions move toward and achieve independence. This proliferation of small and minuscule nations is largely a product of the swift unraveling of colonialism after World War II, though in Central America it goes far back into the last century.

Uncertain Prospects for Regional Integration

In principle, one way of meeting this dilemma is by integration of these splinter economies into larger and more viable regional groupings following, at a great distance, the example of the European Common Market. There are excellent reasons favoring this course and commending it to outside support—even apart from any hope which harried officials in developed countries may hold of being thereby relieved in some measure of the problem of increasing imports from the less developed countries.

So far, efforts to combine into larger regional entities have brought little specific result. In some areas, the trend is rather the other way, as indicated by the strains and disruptions experienced in the West Indies, Malaysia, East Africa, and Nigeria. Little progress is evident in the Maghreb, which was supposed to embrace the Arab States of North Africa. The most promising of these regional endeavors, the Central American Common Market, illustrates the limitations more than the potentialities of such arrangements. It brings together a fairly homogeneous group of countries, compared with most others, and even so adds up to only 12 million people with a combined purchasing power less than that of any one of a number of European and American cities. Now a far larger, more difficult, and more distant objective has been set with the commitment by the heads of the Latin American States in April 1967 at Punta del Este, "Beginning in 1970, to establish progressively the Latin American Common Market, which should be substantially in operation within a period of no more than fifteen years."⁴ The length of the period set for achievement of the objective attests to the difficulties to be overcome.

In some regions political and social frictions may well be the major obstacle to regional integration. The economic difficulties include disparities in the levels of development attained by different countries of the same region, since laggard countries tend to fear competition by their more advanced neighbors. Even more awkward problems may be presented by disparities among countries in the levels and

⁴ From the "Declaration of the Presidents of America," Department of State Bulletin, May 8, 1967, pp. 712-721.

structures of production costs and prices. Barriers of the latter nature are, in turn, largely the result of the exaggerated pursuit of "import substitution" as a means of promoting industrial development.

COSTS OF EXCESSIVE IMPORT SUBSTITUTION

A developing country has some room for choice in orienting its new industries toward replacing imports rather than expanding exports. Initially, the emphasis is likely to be on the former course, since imports attest to a market already in being at home and susceptible of being reserved against foreign competition. Most and perhaps all developed countries have followed this course in the early stages of their growth and, indeed, still cling to protection even though with little basis any more for invoking the "infant industry" argument. Within limits, this course is consistent with the "overspill" view of exports, since, if the industries chosen for protection are well suited to a country's potentials, substitution for imports in its home market may set the stage for competition in export markets later on.

These limits, however, can be quickly exceeded. A less developed country's imports typically embrace a far greater variety of goods than its exports. The difference is all the more striking if one considers not merely final goods but also the materials, parts, and capital equipment entering into their production. Import substitution may therefore soon spread a country's resources too thin over numerous small and insufficient enterprises, and extend to types of production ill suited to its conditions, with the unfortunate result of raising costs even in industries in which it should otherwise be able to compete. A further consequence is to deny the economy the stimulus to efficiency and innovation which exposure to competition in domestic and foreign markets can provide.

In other words, "backward and forward linkages" with other industries may prove to be a burden rather than a blessing if the industries selected for promotion are not well suited to a country's capabilities and size. This may happen even in the largest of the less developed countries.

Considerable caution would therefore seem to be warranted with respect to the various internal and external economies which have frequently been invoked in favor of capital-intensive industries at early stages of economic development.

The frustrations of import substitution were the subject of an urgent warning by Raúl Prebisch in his advance message, as Secretary General, to the United Nations Conference on Trade and Development. Based largely on his close observation of the Latin American countries, he found that the "easy phase" of import substitution had about reached its limit in the countries which had followed that course, and that it could not go farther without considerable waste. He also found that high tariffs to protect narrow national markets had "encouraged the establishment of small uneconomical plants, weakened the incentive to introduce modern techniques, and slowed down the rise in productivity."

"Thus," Prebisch continued, "a real vicious circle has been created as regards exports of manufactured goods. These exports encounter great difficulties because internal costs are high, and internal costs are high

because, among other reasons, the exports which would enlarge the markets are lacking. Had it been possible to develop industrial exports, the process of industrialization would have been more economical, for it would have made possible the international division of labour in manufacturing."

Responsibility for exaggerated import substitution does not fall only on the governments of the less developed countries and their advisers. Two World Wars and the great depression in between were reason enough for many countries to try to produce at home what, in those circumstances, they were no longer able to buy abroad. But the least to be said in criticism of the less developed countries is that so far they have shown little tendency to reverse course and expose their small monopolies to outside competition.

REGIONAL OR INTERNATIONAL INTEGRATION

Under the conditions described, negotiations for regional integration by various groups of less developed countries are likely to mean hard bargaining for mutual support, and reciprocal sacrifice, of high-cost industries. With each participant concerned lest it lose more than it gains, the difficulties of arriving at agreement and successful implementation are apparent.

Considered in this light, it may be significant that the one regional grouping which has been showing signs of progress toward integration—the Central American Common Market—is one whose member states had previously remained relatively open to the outside world and consequently did not differ widely from each other in their cost and price structures. Nor, it must be added, did the members differ much in the relatively low state of their industrial development. There may be, in fact, some risk that the progress now being registered in their manufacturing output and in their trade with each other could prove to be another example of what Prebisch called the "easy phase" of import substitution. The outcome is likely to depend on how successful they are in diversifying and expanding their exports to other countries at the same time they increase their trade within the area.

Political conditions permitting, other countries with relatively simple and open economies may be able to form local economic unions on the Central American model. That experience also suggests the paradoxical thought that countries whose import substitution has gone much further, such as most of the other Latin American countries, may be able to move toward regional integration only by first reintegrating with the world economy and bringing their cost and price structures more in line with those outside. A different, and perhaps more realistic, strategy is evidently reflected in the renewed effort toward economic union undertaken at Punta del Este; namely, as Joseph Grunwald has expressed it, that integration is a "means of lifting the Latin American countries to a level of economic maturity where, without the aid of inefficient protection, they will eventually be able to compete as equal partners with the developed nations."

The expectation underlying this strategy, as expounded by Grunwald, is that integration would expand market perspectives, allow a more rational allocation of resources, permit economies of scale, spur competition, and stimulate private investment. Also, a "protected regionwide market" would provide the catalyst needed to break down

economic, political, and social rigidities and restore economic viability.

This may be a correct appraisal of the Latin American problem and the most promising way of accelerating growth in the region. It seems unlikely, however, that this approach will significantly alleviate the need for a rapid increase in exports to other areas, particularly in view of the extended period—1970–85—over which the common market is to be achieved. In the worst case, regional integration could hinder such an increase in exports if it were to mean the spread of cost-raising import substitution to countries in the region which, otherwise, would set their policies toward becoming more competitive in world markets.

To recapitulate, this study accepts as its point of departure that if the less developed countries are to earn foreign exchange in amounts commensurate with their needs, they will have to achieve a rapid increase in their exports of manufactures to the developed countries. This is where the world's buying power is concentrated, as long as levels of economic development remain so far apart, and it is also where the less developed countries will have to obtain most of the capital equipment and much of the materials and even some of the food needed by their growing economies and population.

FACTOR INTENSITIES IN THE UNITED STATES AND ABROAD

The next question is to try to identify the kinds of manufactures in which the less developed countries are most likely to hold or to be able to achieve a comparative advantage in international trade. The "factor-proportions" theorem identified with Heckscher and Ohlin provides a persuasive, but much disputed, answer to this question. According to that theorem, countries may be expected to have a comparative advantage in goods requiring relatively large inputs of the particular factors of production—whether labor, capital, or natural resources—with which they are most liberally endowed and, correspondingly, a comparative disadvantage in the production of goods embodying their scarce factors. A given country would therefore export goods of the first type and import goods of the second type—on the assumption that there are no hindrances to the flow of trade. In the context of the present study this would mean that, apart from industries based on such natural resources as they might have, the less developed countries would tend to specialize in labor-intensive goods and to import capital-intensive goods. More developed countries with greater capital resources and a highly skilled labor force would show the opposite pattern, at least in their trade with less developed countries.

The criterion used here for measuring, or at least approximating, inputs of both human capital and physical capital on a common basis will be value added by manufacture per employee. Put very loosely, "value added by manufacture" is what remains after subtracting the value of materials consumed from the gross value of output in any given industry or industry group. Differences from industry to industry in value added per employee are assumed to measure differences in the aggregate flows of services from the factors of production employed in the manufacturing process (and exclude therefore indirect factor inputs such as materials used). It is further assumed that these services may be ascribed either to human capital or to physical capital, and that, in interindustry comparisons, the wage and salary

part of value added is a good proxy for the first and the remainder of value added a good proxy for the second.

Though affected by various market imperfections, value added per employee has significant advantages as a measure of factor intensity in manufacturing. One is that this measure may be taken to reflect the flows of services into the manufacturing process from both human capital and physical capital, and permits their treatment on a common basis. Another advantage is that value added per employee is available in considerable industrial detail for the United States and a number of other countries from their censuses of manufactures. The use of this measure contrasts with the usual reliance on more infrequent statistics of stocks of physical capital as a measure of capital intensity, sometimes supplemented by verbal qualifications with regard to skill requirements.

To test the validity of this approach, value added per employee is broken down into its wage-and-salary component and the rest, and significant relations are found across industries between the first and other measures of skill and between the second and stocks of physical capital. It appears that value added per employee is a reasonably good, though not infallible, guide to the capital intensity of different industries.

By this criterion, the labor-intensive industries include such major industry groups in the census of manufactures as textiles, clothing, lumber and wood products, furniture, leather and leather products, and the broad group of miscellaneous manufactures. These main industry groups are relatively homogeneous in that very few of their component industries exceed the national average for wage and non-wage value added.

Industries which are extremely capital-intensive by both criteria employed here include chemical products and petroleum refining. Another industry which would fit into this category is the tobacco industry, ranking very high in nonwage value added though low on the wage scale. Here again there is a high degree of homogeneity in the component industries of these major groups.

The remaining major industry groups fall closer to the overall averages of wage and nonwage value added for all U.S. manufacturing. They are also much more diverse in composition by these criteria. Some of the latter fall well within the capital-intensive sector—for example, blast furnaces and steel mills, primary nonferrous metals, automobiles, tires and tubes, paper and paperboard mills, hydraulic cement, flat glass, alcoholic beverages, flour mills, sugar refining, and some other food processing industries. Other components fall well within the labor-intensive sector, including a number of items of interest in the present analysis—rubber shoes, motorcycles and bicycles, cutlery and various other metal products, pleasure craft and other small boats, glass containers, chinaware and pottery, ceramic tiles, canned seafood, canned fruit and vegetables, paper and paperboard containers, and various kinds of printed matter and printing services.

This allocation leaves a number of other industries and products near, or beyond, one or the other of the margins of the labor-intensive sector, among them being metal castings and stampings; hardware and tools; plumbing and heating equipment; household fans, automo-

tive electrical equipment, radio and television sets, and other light electrical goods; sewing machines and typewriters; various types of machinery; surgical and medical instruments; some measuring or scientific instruments; and watches and clocks.

As will be noted later, most of the items just enumerated are marginal also in the sense that exports by less developed countries form only a very small part of international trade in these goods. They are nevertheless of particular interest, since these products could be regarded as next in line for the achievement of an export potential by some of the less developed countries as the growth of their experience and capacity in manufacturing permits them to move beyond the more strongly labor-intensive types of production. And one may further observe that the development of labor skills (including managerial experience and technical abilities) seems no less important than the growth of physical capital, if this kind of evolution is to occur.

It may be asked, however, whether any pattern of industries by factor intensity discerned for the United States would hold true for other countries. Doubt on this score is natural, given the lower wage rates and higher capital costs generally prevailing in other countries, especially the less-developed ones. All industries will no doubt tend to use more labor in relation to capital in poor low-wage countries than in richer ones, at least in auxiliary services if not in basic production processes. But if this substitution were stronger in some industries than in others, the ranking of industries by factor intensity would also differ from country to country. And if the tendency were widespread, it would mean that—contrary to the “strong factor intensity” hypothesis underlying the factor proportions theorem—one could not confidently rank industries according to their requirements of labor and capital nor look at the relative factor endowments of different countries for clues to the likely composition and direction of their foreign trade.

Despite problems of comparability, the analysis of value added per employee in the United States and other countries developed at various levels of industrial aggregation gives little evidence of factor-intensity reversals. The comparisons tend rather to support the strong-factor-intensity hypothesis underlying the factor-proportions theorem and, more specifically, the relevance of the U.S. pattern of factor intensities to other countries at very different levels of economic development and with very different factor-price ratios. The selection of labor-intensive manufactures based on value added per employee in the United States stands up well on the basis of similar data for other countries, including detailed comparisons with the United Kingdom, Japan, and India.

Apart from any influence which may be exerted by differences in factor-price ratios, the interindustry pattern of factor intensities may change because the rate of technological advance is faster in some industries than in others, leading to new combinations of the factors of production. And these changes may be registered sooner in some countries than in others, depending on technological leadership, entrepreneurial initiative, and the conditions of competition.

In recent years a good deal of attention has been given to the rate of technological progress and changing factor proportions in textiles, especially cotton textiles. Thus, A Study on Cotton Textiles prepared

by the GATT Secretariat,⁵ states that "the industry is continually improving its performance through a shift to new types of equipment embodying technical advances and innovations at every stage of production," and that "the cotton industry in the industrialized countries and some of the less developed exporting countries is undergoing fundamental changes." "Use is being made of huge investments for this new equipment," the GATT study reports, and it adds: "A modern cotton industry is regarded as being among the most highly capital-intensive of the manufacturing industries."

How far this and other similar assessments are correct is important for reasons that transcend the identification of labor-intensive manufactures for analytical purposes. For one thing, technological advance in textiles is thought to have been stimulated by the rapid growth of exports by some of the less developed and other low-wage countries. Developments in the industry could therefore be regarded as illustrative of the kind of competitive response which, in still other products, could slow down or even thwart the growth of exports by less developed countries. Secondly, the prospect of a highly capital-intensive cotton textile industry is sometimes invoked as a reason why, in the meantime, imports from less developed countries should be curbed.⁶ Commercial policy is thus summoned to the support of economic projections.

While the rate of technological innovation in cotton textiles is impressive, it may be exaggerated to suppose that the process is significantly faster than in manufacturing as a whole and to conclude that the industry is becoming strongly capital-intensive. The evidence for the United States is consistent with the view that there has been heavy investment in modernization in the last few years in cotton textiles, but it gives little reason to think that the industry is becoming capital-intensive compared with manufacturing in general and ceasing to be appropriate to the factor endowments of the less-developed countries. According to the criteria applied in this study, cotton textiles and the textile industry in general still rank among the most labor-intensive of the manufacturing industries, and they will be so treated in the analysis of trade.

The contrary view that a fundamental change in textiles is under way may rely unduly on comparisons with the industry's own past characteristics and performance and fail to allow for the progress made by manufacturing in general. The illustrations frequently given of developments in the industry also suggest a tendency to confuse the technological optimum with average practice at any one time.

CHAPTER II. TRADE IN LABOR-INTENSIVE MANUFACTURES

CHARACTERISTICS OF THE TRADE

Probably the most important generalizations that can be made about imports of labor-intensive manufactures by developed from less developed countries are, first, that these imports are small and, second, that they have been growing rapidly in recent years.

⁵ General Agreement on Tariffs and Trade, Geneva, July 1966. The passages cited are from p. 55.

⁶ For further discussion of the responses of developed countries to increased imports of textiles from the less-developed countries see p. 237.

Another broad generalization is that the trade is rather uneven in its composition by products and in its distribution by both exporting and importing countries. By product, textiles and clothing make up a particularly large share of the total, though some other light manufactures have recently been rising more rapidly. Among the countries of origin, Hong Kong holds an extraordinary position, and, all together, the less developed countries of the Far East are paramount over other areas as suppliers of labor-intensive manufactures to developed countries. Among the latter, the United States, the United Kingdom, and West Germany account for by far the greater part of these imports, and they also take the greater part of imports of labor-intensive manufactures from Japan and other low-wage countries.

Relative Size of Imports

A noteworthy feature of this trade is the small size of U.S. imports of labor-intensive manufactures from the less developed countries in relation to U.S. production of similar goods. The value of U.S. output (or "value of shipments") in 1965 of the items selected as labor-intensive was \$138 billion. Imports of these items from all sources in 1965 were equal to only about 4.1 percent, and those from less developed countries only 0.7 percent, of that amount. These ratios were particularly low for certain items which may be described as "marginally labor-intensive." Exclusive of these items, total imports were about 4.2 percent, and import from the less developed countries about 1.1 percent, of domestic output. A similar comparison, if it could be made, would probably yield a slightly higher ratio of imports from the less developed countries to the domestic production of other developed countries considered as an entity, but with sharp contrasts among the members of the group.

Looked at in relation to total imports of labor-intensive manufactures, the share supplied by the less developed countries is much larger in this country than in other developed countries—about 18 percent for the United States in 1965 versus 6 percent for other developed countries taken as a whole, or 25.8 and 10.5 percent, respectively, exclusive of the "marginal" items. This observation has to be set against the much more limited role which imports in general play in the U.S. economy than in most other countries. Even so, the ratios (again exclusive of the marginal items) seem very small in most cases—between 3 and 8 percent in all of the smaller European countries and Canada. In France, despite its longstanding economic ties with African countries and the tariff preferences extended to them, the 1965 ratio is only 12.3 percent, or slightly larger than in West Germany with 11.1 percent and much less than in the United Kingdom with 19.2 percent.

As a final comparison, on the basis of the 1965 trade returns, labor-intensive manufactures make up less than one-tenth of total imports of the developed countries from less developed countries. Coffee, cocoa, and tea alone bulk larger in the total, and crude petroleum 2.7 times larger. Labor-intensive manufactures are less than half as large as other products classed as "manufactures," the latter being more capital-intensive and generally having an evident natural-resource orientation (major examples being petroleum products and nonferrous metals). The only items of which the latter is not true are of negligible consequence in the trade.

It is noteworthy, however, that developed countries' imports of labor-intensive manufactures from the less developed countries rose by almost 11 percent from 1964 to 1965 in contrast to an increase of less than 4 percent in all other products. This relative gain was achieved despite the fact that the defensive balance-of-payments measures taken by the United Kingdom toward the end of 1964 and, more particularly, the tightening of restrictions on textiles seem to have fallen with special severity on its imports of labor-intensive manufactures from some of the Commonwealth countries. Developed countries other than the United Kingdom raised their imports of labor-intensive manufactures from less developed countries by 17.5 percent in 1965.

Product Composition of the Trade

Textiles, clothing, and accessories made up about one-third of 1965 imports of labor-intensive manufactures by developed from less-developed countries. (If burlap and other coarse fiber products are also counted in the textile group, the latter accounted for some 44 percent of the total.) The concentration of the trade by product is therefore pronounced, but it is perhaps less extreme than sometimes suggested by the attention given to textile imports from low-wage countries. Comparison of the 1965 results with those for 1964 indicates, moreover, that the concentration may be diminishing, the textile items having increased by 10.4 percent compared with an overall increase close to 27 percent by a wide assortment of miscellaneous light manufactures (excluding food items and industrial materials). Both figures are strongly influenced by the British measures noted above. Developed countries other than the United Kingdom increased their imports of textiles, clothing, and accessories by about 25 percent and those of miscellaneous light manufactures by 37 percent from 1964 to 1965. The corresponding increases for the United States alone were 34 and 44 percent, respectively.

Distribution by Importing Countries

Of total imports of labor-intensive manufactures by developed from less-developed countries in 1965, the United States accounted for 41.4 percent. The United Kingdom was next with 17.6 percent, and West Germany third with 12.7 percent. Together, these three countries took almost 72 percent of the total. The United Kingdom's share had been as high as 22 percent in 1964, but was reduced in 1965 with the absolute decline in its imports from the less-developed countries, while those of the United States and West Germany continued to rise.

Rapid increases are also found for several countries—Sweden, Austria, Japan, Australia, and New Zealand—whose imports are relatively small. Others, including the European Common Market members except West Germany, show small shares in total imports of labor-intensive manufactures from the less-developed countries, small ratios to their own imports of like products from all sources, and low rates of increase.

There are considerable differences in the distribution of the main product groups among importing countries. The share of the United States is particularly high—more than half of the total—in the rapid-growth miscellaneous light manufactures. The Common Market countries take a relatively large part—twice as much as the United States—of the labor-intensive food products. The United States, the United Kingdom, and West Germany account for three-quarters of total im-

ports of textiles, clothing, and accessories from the less-developed countries. All three show considerable variety in the product composition of their imports from the less-developed countries. The United Kingdom's imports are, however, more concentrated on Commonwealth countries, which enjoy preferential entry to the British market, than those of the United States and West Germany. The much smaller total of French imports of labor-intensive manufacturers from the less-developed countries is composed to the extent of two-thirds of food products, leather, and lumber, chiefly from Africa. Japan's imports of labor-intensive manufactures from the less-developed countries are extraordinarily small by almost any standard. In these products Japan's role vis-à-vis the less-developed countries is, at least for the time being, far more that of a competitor than that of a customer.

Distribution by Exporting Countries

Hong Kong alone supplied 28 percent of total imports of labor-intensive manufactures by developed from less-developed countries in 1965, outranking India and the whole of Latin America with less than one-fifth each. The extraordinary role of Hong Kong is not sufficiently indicated by the overall percentage just cited: Its share in labor-intensive food products and industrial materials was negligible, reflecting its lack of land and other natural resources, but it supplied half of the textile group and more than half of miscellaneous light manufactures.

Other less-developed countries of the Far East brought the combined share of that area to two-thirds of the total. Extraordinarily rapid rates of increase from 1964 to 1965 were shown by several of these countries, notably South Korea and Taiwan. It may be noted that their highest rates of increase were in miscellaneous light manufactures, and this was generally true of the less-developed countries in other regions as well.

No less remarkable than the vigor shown by the exports of some of the small Far Eastern countries is the failure of some of the larger less-developed countries, with an earlier beginning of industry, to compete on a significant scale in the markets of the developed countries for labor-intensive manufactures. These countries include Argentina, Brazil, Chile, Mexico, the Philippines, Egypt, Algeria, and Morocco. With the exception of Brazil, whose exports in 1965 gave some promise of renewed growth, these countries also failed to share in the general rise in exports of labor-intensive manufactures from the less-developed countries in 1965. Their participation is especially weak in miscellaneous light manufactures, which include some of the more rapidly growing items. Nor should it be supposed that the minor role played by these countries as exporters of labor-intensive manufactures to the developed countries is to be explained by a more impressive performance in capital-intensive manufactures. Exports of such manufactures by the less-developed countries, apart from strongly resource-based products, are exceptional. Some of the exceptions are, however, of possible interest in the present connection. They include \$15,758,000 of iron and steel exported by Mexico to the United States; \$1,002,000 of tires and tubes exported by Israel to Western European countries as well as smaller amounts from Morocco, India, and the Philippines; \$363,000 of trucks from Morocco to France; and \$90,000 of insulated wire and cable exported by Argentina to the United States.

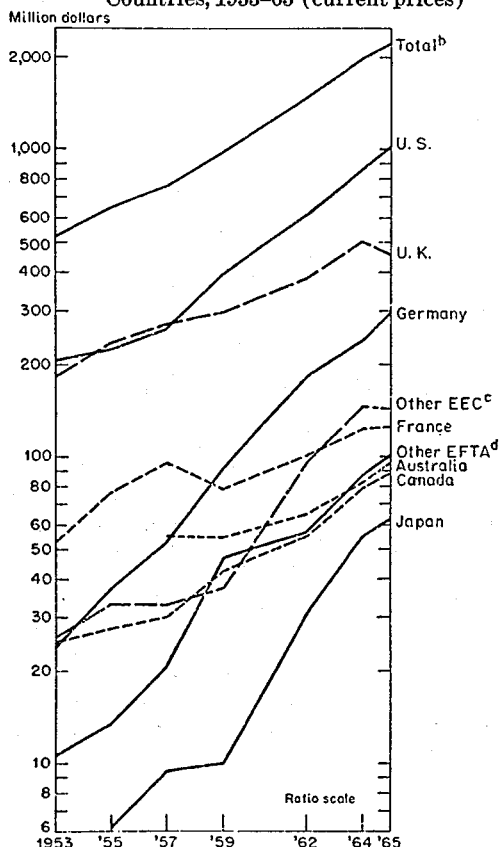
MARKET POTENTIALS

Past Growth, 1953-65

The rate of growth in imports of labor-intensive manufactures by developed from less developed countries in recent years has probably been much faster than had been expected. For instance, in a study published in 1964, Bela Balassa projected an annual rate of increase of 5.5 percent in exports of manufactures by less developed to developed countries over the period from 1960 to 1975, prices being assumed to remain constant.⁷ By contrast, the total of the labor-intensive items plotted in chart II-1 shows imports in 1965 $4\frac{1}{3}$ times as

CHART II-1

Imports of Labor-Intensive Manufactures by Developed from Less Developed Countries, 1953-65 (current prices)



Source: Compiled from publications of U.N. Statistical Office.

^a Imports of countries reporting on a c.i.f. basis have been adjusted to an approximate f.o.b. basis.

^b Excluding Australia, Japan and Switzerland.

^c Belgium-Luxembourg, Italy and the Netherlands.

^d Austria, Denmark, Norway and Sweden (Switzerland and Portugal not included).

⁷ Bela Balassa, "Trade Prospects for Developing Countries," Homewood, Ill., 1964, p. 66 and tables A3.1.1 and A12.

large as in 1953, an increase of about 13 percent per annum compounded. This is at current prices, and the annual rate of increase might be 1 or 2 percentage points less at constant prices.

In other words, the increase foreseen for 15 years was approximately realized in 5 years. As table II-1 shows, the strength of actual performance in relation to the projections was pervasive, extending to most product groups and geographic areas.

Structure of Wages in Less Developed Countries

One of the conditions for a continued rapid growth of the trade is that the structure of wages in less developed countries not be such as to nullify their comparative advantage in labor-intensive products. A few years ago Lloyd Reynolds suggested that "interindustry wage dispersion tends to reach a maximum some time during the early stages of industrialization and to diminish gradually after that point."⁸ This is what one would expect under free-market conditions, assuming that skills are relatively short and unskilled labor abundant in newly developing countries, and that these disparities in supply are gradually overcome.

Recently, however, a growing literature indicates that interferences of one kind or another tend to narrow wage differentials between industries or occupations in many of the less developed countries and so to raise costs in their more labor-intensive manufacturing branches. Frequently the stress is placed on labor unions as the main force underlying the development of wages. Legal minimum wages may, however, be a more general and powerful influence on the level and structure of wages in less developed countries to a degree not matched in more developed countries. An authoritative analysis in the organ of the International Labour Office,⁹ in discussing changes in wage differentials by skill in the less developed countries, attributes minimum-wage policies to widespread disapproval of the wage levels of unskilled workers that would otherwise obtain. But he adds that "if governments insist that unskilled wages should increase independently of the forces of demand for and supply of unskilled labor, there is a likelihood that unskilled wages may increase faster than skilled wages." The author then quotes an earlier article in the same review (1959), finding "an extreme uniformity of wage rates in Brazil" attributable to public intervention, particularly the minimum wage, and cites other evidence of a tendency for the skilled-unskilled wage differential to narrow in "many African countries" and "some Asian countries." "This," he explains, "is because legal minimum wages are relatively high in these countries and are raised from time to time irrespective of the underlying conditions."¹⁰

Several unfavorable economic consequences are associated with tendencies toward uniformity of wage rates irrespective of skills. One is the discouragement of effort by workers to acquire higher skills. Another is the inducement to entrepreneurs to adopt more capital-intensive methods of production than they otherwise would or to save on labor in other ways, thus inhibiting the growth of employment. A

⁸ L. G. Reynolds and C. H. Taft, *The Evolution of Wage Structure*, New Haven, 1956, p. 356.

⁹ "Wage Differentials in Developing Countries: A Survey of Findings," by Koji Taira, *International Labour Review*, March 1966, pp. 281-301.

¹⁰ P. 287.

TABLE II-1.—IMPORTS OF MANUFACTURES BY DEVELOPED COUNTRIES—IMPORTS IN 1960 AND 1965 AND BALASSA'S PROJECTIONS FOR 1975

[In millions of dollars]

Product group	Imports in 1960 (current prices)					Imports in 1965 (current prices)					Balassa's projections for 1975 (1960 prices) (average of high and low)				
	All developed countries	North America	Western Europe	Japan	Oceania	All developed countries	North America	Western Europe	Japan	Oceania	All developed countries	North America	Western Europe	Japan	Oceania
1. Chemicals.....	119	54	59	5	1	267	109	131	22	5	227	100	111	15	1
2. Leather and footwear.....	81	14	64	2	1	132	36	90	5	1	154	36	106	10	3
3. Veneer, plywood, wood and cork manufactures, and paper.....	50	25	23	-----	2	140	97	39	1	3	268	179	84	-----	5
4. Textile yarn, cotton fabrics, and clothing.....	316	145	151	-----	20	622	285	297	2	38	658	281	332	-----	45
5. Jute manufactures.....	175	103	34	1	37	279	192	46	-----	42	217	121	50	1	45
6. Floor coverings and other textile products.....	102	39	59	1	3	217	65	142	3	7	246	79	156	4	7
7. Silver, precious stones, pearls, and jewelry.....	94	28	64	2	-----	277	95	161	20	1	291	88	190	9	4
8. Machinery and metal manufac- tures.....	42	20	21	-----	1	252	117	108	24	2	132	62	66	-----	3
9. Other manufactured goods.....	96	53	37	1	5	284	173	89	10	12	253	138	97	4	14
Total.....	1,075	481	512	12	70	2,470	1,169	1,103	87	111	2,446	1,084	1,192	43	127

third effect of particular relevance here is the brake on the diversification of exports: A country unable to compete abroad in capital-intensive manufactures may also find itself priced out of the market in more labor-intensive manufactures and thus forced to continue to rely on exports of primary products.

These considerations may help to explain why it is that some of the less developed countries, notably those with an earlier start on industrialization, have fared so poorly in exporting manufactures and why, in contrast, some others, particularly some of the countries of Southeast Asia, have made such rapid headway.

Possible Areas of Rapid Growth

At least for those less developed countries which do strengthen their comparative advantage in labor-intensive manufactures, the very unevenness of the trade hitherto may provide a key to future growth sectors. Imports from less developed countries of many light consumer manufactures have scarcely scratched the surface of the market. This certainly seems true of the United States on even a rough comparison of domestic production and imports from the less developed countries. There are, indeed, very few products of which total U.S. imports from all sources make up a significant part of supply. It seems plausible to expect that a growing, adaptable economy will absorb increasing amounts of these miscellaneous consumer goods from the less developed countries.

This may be true also of many other developed countries, in some of which imports of consumer manufactures from the less developed countries have scarcely begun to play a role. Restrictive import policies and practices are doubtless one explanation. But perhaps also a learning period is required, and the experience gained by some of the less developed countries in exporting to the larger and higher cost U.S. market, and by those of the Commonwealth with their privileged access to the British market, may now be applied to the conquest of still other markets.

Some of the greatest opportunities for expansion may be offered by marginally labor-intensive manufactures. The field of components and parts for use in electronic products and perhaps also in machinery, automobiles, and other transportation equipment seems particularly interesting. American manufacturers of electronic goods have reached out not only to Japan and Puerto Rico but also to Hong Kong, Taiwan, and Korea for components or even complete products.

CHAPTER III. COMMERCIAL POLICIES OF DEVELOPED COUNTRIES

The assessment of market potentials concluding chapter II may be too optimistic. How far the expansionary forces go depends heavily on the commercial policies of the developed countries with regard to imports of manufactures from less developed countries. It remains therefore to consider in this regard both the tariff structures of the developed countries and nontariff barriers which, in some cases, may have a far more restrictive effect.

TARIFF STRUCTURES: NOMINAL VERSUS EFFECTIVE RATES

A standing complaint of less developed countries is that the import tariffs of the developed countries tend to be graduated according to stage of manufacture so as to bear lightly, if at all, on imports of

raw materials for use in manufacture and to penalize imports of processed or finished goods. To the extent that these influences prevailed, many of the less developed countries would have to remain hewers of wood and drawers of water.

Theoretical and empirical support for the view that the "escalated tariff structures" of the advanced countries are "a potentially powerful inhibitor of economic growth in the underdeveloped countries" has been developed by a number of distinguished economists. Their analyses make the point that nominal tariffs may be quite different from effective tariffs, the latter being related to value added by manufacture after taking account of duties paid on material inputs. When the rates specified in the tariffs are graduated according to stage of manufacture, the effective rates are higher, and frequently much higher, than the nominal rates.

Suppose, for example, that an important consignment of cotton cloth worth \$500 is subject to an import duty of \$100. Suppose further that the same amount and quality of cloth produced at home would require \$240 of yarn which, if imported, would bear a duty of \$30. In this case the value added by weaving is \$260, protected by a duty of \$70.¹¹ The effective rate of duty, computed in relation to value added, is therefore 26.9 percent as contrasted with the nominal rate of 20 percent.

Moreover, it may be more meaningful to relate the duty only to the wage part of value added on the assumption that capital costs are not likely to be lower, and may well be higher, in less developed than in developed countries. On this basis, and assuming that payroll makes up 60 percent of value added in the example chosen, the effective rate of protection would be about 45 percent. This would be the amount by which labor costs per unit of output in the importing country could exceed those in the exporting country. The difference will be greater still to the extent that capital costs, transportation charges, and other costs work in favor of the importing country. (And, of course, the difference in earnings per worker will be much greater still when the difference in productivity of labor is as large as it typically is between less developed and developed countries.)

Table III-1 drawn from a current study by Balassa, presents nominal tariff rates and estimates of the effective rates, on both of the bases just described, for a number of intermediate products and finished manufactures of interest in this study. These estimates necessarily involve an element of approximation regarding input coefficients and can perhaps best be regarded as illustrative rather than as precise measurements. In most cases the effective rates are much higher than nominal tariffs. The effective rates in Japan are in most instances higher than in the United States or the Common Market. In the United Kingdom, the structure of protection is not very different from that of other developed countries as far as tariff rates imposed on imports from outside the Commonwealth are concerned. These rates are, however, of less relevance than those of other countries (and are accordingly omitted from the table), since imports from the Commonwealth, including such major suppliers as Hong Kong and India, are generally free of duty (though not necessarily free of other restraints, as in cotton textiles and jute products).

¹¹ It is relevant to the history of economic doctrine to note that this example is drawn from a study of tariff protection and free trade published more than 60 years ago by the Austrian economist and former Undersecretary of State Richard Schüller.

TABLE III-1.—NOMINAL TARIFF RATES AND ESTIMATED EFFECTIVE RATES ON IMPORTS OF SELECTED INTERMEDIATE PRODUCTS AND FINISHED MANUFACTURES BY THE UNITED STATES, THE EUROPEAN ECONOMIC COMMUNITY AND JAPAN

[In percent]

SITC No.	Product	Nominal tariff rates			Estimated effective rates on value added			Estimated effective rates on value added by labor ^a		
		Nominal tariff rates			Estimated effective rates on value added			Estimated effective rates on value added by labor ^a		
		United States	EEC	Japan	United States	EEC	Japan	United States	EEC	Japan
INTERMEDIATE PRODUCTS										
6513	Cotton Yarn and thread	13.1	10.0	5.6	32.8	31.4	13.9	46.0	44.0	19.5
6512	Yarn of wool and animal hair	23.0	5.7	10.0	53.2	16.1	29.6	74.5	22.5	41.5
611	Leather	9.6	7.3	19.9	25.7	18.3	59.0	48.1	34.3	110.4
243	Wood, shaped or simply worked	.7	3.2	5.9	1.1	4.5	13.3	1.9	7.5	22.5
FINISHED MANUFACTURES										
652	Cotton fabrics, woven	17.5	15.0	10.5	31.2	27.5	20.0	43.4	38.5	27.8
6532	Woolen fabrics, woven	50.1	16.0	20.0	119.1	36.9	43.1	165.6	51.3	60.0
841 a	Cotton clothing	26.6	18.5	21.0	48.1	28.1	40.3	77.4	45.2	64.8
841 b	Wool clothing	22.1	20.5	22.0	-5.4	32.4	30.8	-8.7	52.2	49.6
6514	Clothing and accessories, knitted	25.6	18.6	26.0	48.7	41.3	60.8	68.5	58.1	85.5
6534	Jute fabrics, woven	2.8	23.0	25.0	7.0	62.2	67.5	9.9	86.6	94.0
6561	Jute sacks and bags	7.5	19.4	25.0	16.6	19.2	34.5	25.0	29.0	52.0
8556	Cordage, ropes, nets, etc.	4.0	14.3	19.2	11.3	41.9	57.2	32.7	121.8	166.4
851	Shoes	16.6	19.9	29.5	25.3	33.0	45.1	47.6	62.0	84.8
612	Other leather goods	15.5	14.7	23.6	24.5	24.3	33.6	34.3	34.0	47.0
631	Plywood	17.1	15.0	20.0	43.7	32.5	44.2	87.5	65.0	88.4
632	Other wood products including furniture	12.8	15.1	19.5	26.4	28.6	33.9	46.4	50.3	59.6

^a The estimated effective rate on value added by labor is the lower of 2 sets of estimates given by Balassa (the higher estimates allowing for higher capital costs in developing countries).

^b Data relate to selected components of SITC No. 841.

Note: Rates relate to structure prior to completion of Kennedy round of GATT negotiations.

Source: Bela Balassa, "The Structure of Protection in the Industrial Countries and Its Effect on the Exports of Processed Goods from Developing Nations" (manuscript).

It is noteworthy that, though the U.S. tariff appears in general to be no less graduated or escalated than those of other countries and is sometimes held to be more so, the effect on the structure of its imports seems to be much less marked than in some other developed countries, especially some of the members of the Common Market and Japan. One important reason is that the United States is itself a major producer and exporter of some of the crude materials included in the table, notably, cotton, cattle hides, and hardwoods. This alone would tend to cause a higher ratio of manufactured to unmanufactured imports than would be true of most other developed countries. The same influence may affect the composition of imports by Canada, Australia, and New Zealand.

Nevertheless, imports of finished manufactures from less-developed countries by most countries of Western Continental Europe look very small, and those of Japan altogether trivial, compared both with their own imports of crude materials and intermediate products and with imports of finished goods by the United States from less-developed countries. Part of the explanation may be that, even if effective tariff rates in the United States are the same as in Europe or Japan, they may be less effective, in fact, in restricting imports of labor-intensive goods, if wage costs per unit of output in manufacturing these goods are higher here than in other developed countries.

· NONTARIFF BARRIERS TO IMPORTS

There are, however, other more specific though sometimes less visible hindrances to the growth of the trade than those presented by tariffs. The most obvious, at least so far as they are reported, are quantitative restrictions. After taking note of some further, but slow, progress in removing these restrictions, a mid-1966 report by UNCTAD observes that "the area of exports still affected is considerable and includes a number of products of major export interest to developing countries." The report then summarizes the position as follows: "Out of 63 Brussels tariff nomenclature items of export interest to developing countries, quantitative restrictions on the following among them are still maintained in the developed countries; namely France 56, Japan 24, Federal Republic of Germany 21, Denmark 15, Norway 14, Austria 13, Italy 10, United Kingdom 7, Switzerland 6, Sweden 3, United States 3, Netherlands 2, Belgium-Luxembourg 2, Canada 1."¹²

It is hard to judge the significance of these restrictions, since they may be nominal in some cases and rigorously enforced in others. It is even more difficult to judge the incidence and effect of other more subtle hindrances, such as administrative redtape or collusion among private producers and distributors within the developed countries, but the absence of trade is sometimes difficult to explain otherwise. Though it is difficult to separate from other influences noted, perhaps something should be allowed for the view that competition is keener in the U.S. market than in other developed countries, and that American entrepreneurs are more active in seeking out foreign sources of supply.

¹² United Nations Conference on Trade and Development, "Review of International Trade and Development, 1966," summary of report by the Secretary-General, July 20, 1966 (TD/B/82), p. 15.

Restraints on Imports of Cotton Textiles

The history of cotton textiles in recent years illustrates how the very growth of trade can be its own undoing through provoking restrictive measures by the importing countries. Following the swift increase in imports of cotton textiles from India, Hong Kong, and other Commonwealth sources in the 1950's,¹³ the United Kingdom made a series of bilateral agreements aimed at limiting the further growth of the trade. The United States, after a rapid rise in imports from some of these countries and from Japan, took the lead in negotiating in 1961 a short-term and then, in 1962, a long-term international cotton textile "arrangement," under which it has made numerous bilateral agreements for "voluntary restraints" by the exporters. Continental European countries were happy to join in the arrangement, with the blessing it confers on avoidance of "market disruption," but for the greater part have continued to prove willing and able to apply their own import restraints.

These restraints are sometimes more than meet the eye. The director-general of the GATT, in opening the major review called for in the arrangement at the end of the third year, noted that all trade restrictions on cotton textiles are not fully notified by participating governments and urged them to help lift the haze which still rests over this subject.¹⁴

Despite these open and hidden restrictions, imports of cotton textiles by the developed countries from developing exporting countries have increased relatively fast. Those of Western Continental European countries doubled from about \$50 million in 1961 to something over \$100 million in 1964. At that level, however, they still fell short of imports from the same sources by the United Kingdom (around \$170 million) and by the United States (\$126 million), both of which had risen substantially as well.

Apart from the United Kingdom, these increases have all been from extremely low levels compared with home consumption—so low in several of the Western Continental European countries that even their commitment to large percentage increases under the 5-year arrangement was regarded by some of the exporting countries as

¹³ The rise in these imports is explained as follows by A. M. Alfred, the chief economist for Courtaulds Ltd., in a paper read at the Manchester Statistical Society on November 10, 1965 ("United Kingdom Textiles—A Growth Industry"):

On the import side, you will know well that the United Kingdom textile industry, particularly the cotton sector, has suffered from an unforeseen consequence of the Imperial Preference Treaty negotiated at Ottawa in 1932. Under that treaty, it was agreed that cotton and wool textiles and madeup goods could enter the United Kingdom duty free if coming from the Commonwealth. At that time there was no textile activity of relevance in India, Pakistan, or Hong Kong. In fact India (then undivided) imported 550 million yards of cloth from the United Kingdom. In 1964 the United Kingdom imported 450 million square yards of cloth and madeup goods from India, Pakistan and Hong Kong—a reversal of a billion yards. This large volume arose because of the channelling of these Commonwealth exports into the only country into which they could come duty free.

After noting that these imports, together with imports from other underdeveloped countries made up 35 percent of British consumption, compared with his estimates of 8 percent for the United States and 9 percent for the European Common Market, Mr. Alfred went on to speak of "the ridiculous state of affairs whereby the United Kingdom cotton industry is the only industry in any developed country of the world to have zero protection against a major supplier."

While recognizing that the "market disruption" in the British textile industry has been far greater than in other developed countries, one cannot fail to detect in this account a double standard frequently characteristic of attitudes in developed countries toward trade with the less-developed countries: Free trade in textiles within the Commonwealth seemed logical and desirable as long as the flow was from the United Kingdom outward, but ceased to be so when the flow reversed (through the initial impact of British factory-produced textiles on the Indian handcraft industry in the 19th century had been no less disruptive than that more recently experienced in the United Kingdom when the tide turned).

¹⁴ Press release GATT/946, Dec. 8, 1965.

bordering on fraud.¹⁵ In his remarks quoted above opening the major review of the arrangement, the director-general of the GATT expressed the hope that it had brought some semblance of order into the trade through restraint actions, and that the parties to the arrangement could begin to give effect to its long-term and positive aims, including in particular expanded access to markets for the less developed countries.

It remains to see how much emphasis will be given to these long-run objectives during the further 3-year period, starting October 1, 1967, for which the cotton textile arrangement has been extended. At least as far as the United States is concerned, government officials reporting to business groups on the renewal of the arrangement have stressed rather the objective of avoiding market disruption, the expectation that the rapid growth of U.S. imports of cotton textiles would be greatly slowed down, the intention of acting to regulate imports from new supplies, and continued close cooperation with the industry through the Management-Labor Textile Advisory Committee.¹⁶ In connection with the extension of the arrangement, stress has also been placed on the limited extent of the tariff cuts on textiles made by the United States and other developed countries in the Kennedy Round.¹⁷

THE PROBLEM OF INCREASED ACCESS TO MARKETS

The issue of preferences

The first condition for a continued rapid growth of exports of manufactures by the less developed countries to the advanced countries would seem to be greater accessibility to these markets. Greater accessibility would mean the scaling down of the tariff rates of developed countries, particularly the effective rates, on goods of which the less developed countries are actual or potential suppliers; the progressive loosening of quantitative restrictions, both those imposed by the importing countries and the voluntary restraints exercised by the exporting countries; and the identification and removal of other, less obvious impediments to imports. More broadly, greater accessibility would mean recognition that international specialization has a place for the products in which the less developed countries have a comparative advantage, and that this place will widen and deepen as the rise in productivity and wages in the developed countries produces divergent effects on unit wage costs in different industries.

The great debate in recent years on commercial policies affecting the less developed countries, culminating at the United Nations Conference on Trade and Development in 1964 and still continuing, has turned increasingly on the issue of tariff preferences; that is, whether the enlargement of market opportunities for the less developed countries should be sought within the most-favored-nation framework embodied in the GATT, whereby the concessions made would be gen-

¹⁵ Gardner Patterson, "Discrimination in International Trade: The Policy Issues, 1945-65," Princeton, 1966, p. 311.

¹⁶ See especially the address by Stanley Nehmer, Deputy Assistant Secretary of Commerce for Resources, before the Underwear Institute in Atlantic City on May 9, 1967.

¹⁷ "Because of the import sensitivity of textiles in general here and abroad, the cuts made by the United States and other major importing countries average less than 25 percent and much less than that on the more sensitive product areas such as woolen and manmade textiles. Many textile products were excluded altogether" (quoted from address by the then Acting Secretary of Commerce, Alexander B. Trowbridge, at the Alabama International Business Forum, Tuscaloosa, May 17, 1967).

eralized and extended also to developed countries, or whether the less developed countries should be accorded preferential treatment in recognition of their difficulties in competing with the developed countries. Rightly or wrongly, the less developed countries seem to have become convinced that only a system of preferences would meet their needs, though they differ among themselves, as well as with the developed countries, as to what the terms of the preferences should be. The United States, adhering to the principle of nondiscrimination, has been in the invidious position of leading the opposition to these demands, sometimes to the point of seeming to be the only voice in opposition. Harry G. Johnson, though severely critical of the negative stance of the United States and of its failure to develop a more positive and imaginative policy, suggests that, to an important extent, the United States served as a scapegoat for other countries, especially the European Common Market countries, which avoided commitment by abstaining from voting while the United States carried the burden of resistance.^{17a}

After the vast exceptions to the most-favored-nation principle constituted by the European Economic Community and the European Free Trade Area, the idea of tariff preferences to favor the less developed countries may appear to be a modest objective. It seems to accord ill, however, with the realities of the present trading situation in which, as the director-general of GATT has observed, "the tendency is, in the sectors where the less developed countries are already competitive, for the developed countries to discriminate against the export products of these countries."¹⁸ Unless the developed countries are ready to forgo those features of their commercial policies which seem to fall with particular severity on exports of the less developed countries, what expectation can there be of shifting all the way over to discrimination in their favor?

The heart of the difficulty, as far as exports of labor-intensive manufactures by the less developed countries are concerned, is that these products tend to compete with those sectors in the developed countries which are frequently the least prosperous and the most successful in obtaining protection against imports. The problem is illustrated by one of the provisions of the U.S. Trade Expansion Act of 1962; namely, that authorizing the President to negotiate tariffs down to zero on groups of industrial products of which the United States and the European Common Market together accounted for 80 percent or more of world exports. This formula reflected an erroneous expectation that the United Kingdom was about to become a member of the Common Market (without which the 80-percent level would be realized only exceptionally). But it also had the important effect of excluding products, notably textiles, of which Japan and the less developed countries were significant exporters. In other words, the United States was prepared to consider reducing tariffs by as much as 100 percent on products which, as President Kennedy said, "can be produced here or in Europe more efficiently than anywhere else in the world,"¹⁹ but only by half as much in principle (perhaps a good deal less in

^{17a} "Economic Policies Toward Less Developed Countries," Washington, 1967, especially p. 39.

¹⁸ Address in Bad Godesberg, Germany, Oct. 27, 1966.

¹⁹ See "Department of State Bulletin," Feb. 12, 1962, p. 236.

practice) on products in which Japan and the less developed countries were most competitive. This, however, is only a specific illustration of the general tendency of U.S. tariffs to bear more heavily on labor-intensive manufactures than on other goods. It raises the question whether, even if the most-favored-nation rule is rigorously respected, unequal tariff treatment of different products may not be tantamount to unequal treatment of different countries.

The Prebisch Proposals

Awareness of these difficulties led Raúl Prebisch, in his advance message as secretary-general to UNCTAD in 1964, to envisage something less than a fully generalized system of preferences.²⁰ As he saw it, developed countries could not be expected to give preferential treatment to those industries in the less developed countries that were already fully competitive in world markets, and each country granting preferences might therefore establish a reserve list of such products to be excluded from preferences (but not, he stressed, from most-favored-nation treatment under GATT). Prebisch's case for preferences was, as he said, "a logical extension of the infant industry argument" aimed at enabling the less developed countries to become competitive in manufactures that they could not now export. Both the duration of the preferences (a minimum of 10 years was suggested) and the margin of preference should be great enough to provide adequate incentive for the establishment of new export industries.

Prebisch considered it desirable, but not indispensable, that all developed countries participate in granting preferences. He hoped that they would avoid the crippling complexities of a highly selective country-by-product approach, but recognized that they might insist on an overall quota, and possibly quotas on particular categories, governing the amount of goods to be imported preferentially.

As to the preference-receiving countries, Prebisch recognized that it would not be easy to set any kind of cutoff point above which countries would not be eligible. Among those which were eligible, he felt it necessary to distinguish between the "more advanced" and the "less developed" among them, suggesting for the latter wider margins of preference. This might be reinforced by a special grant of quotas in their behalf and perhaps even by preferential tariff treatment on items which the developed countries had reserved from general preferences.

Australian Preference System

Despite vigorous efforts by the less developed countries at UNCTAD for a declaration of principle in favor of preferences, all that emerged in the final act of the 1964 conference was a decision to set up a committee to consider the best method of implementing such a system and to discuss differences of views on the question of principle. The topic seems destined to figure even more prominently in the debates of the second conference scheduled for 1968. Meanwhile, the only specific action by way of preferences favoring imports from the less developed countries is that taken by Australia under a waiver from the most-favored-nation rule approved by GATT in March 1966. Though staunchly defended by Australia as a manifestation of its willingness to

²⁰ "Proceedings of the United Nations Conference on Trade and Development," vol. II, policy statements, 1964, pp. 35-40.

help overcome the trade problems of the less developed countries and as a lead to other developed countries wishing to apply similar methods, the Australian preferential system may also be taken as indicative of the limitations and problems in this approach. Its main features may be summed up as follows from materials made public at the time of requesting the waiver from GATT:²¹

1. Preferential duties, zero in some cases, were to be introduced in favor of the less developed countries, comprehensively defined, on some sixty items.

2. Each such concession was, however, subject to a quota limit, above which regular duties would apply to imports from less developed countries.

3. These quotas added up to a total of £A6,680,000, or about \$15,000,000, representing in principle the amount of goods that might enter in a year's time on a preferential basis.

4. More than 40 percent of this total was made up of items which, it would seem, were unlikely to provide the basis for any new export industries in less developed countries, at least in the near future. These included, in particular, newsprint, £A2,000,000; machinemade paper £A500,000; rubber thread, vulcanized, £A100,000; household washing machines, £A150,000; machine tools £A150,000.

5. Other, generally more likely, items thus added up to £A3,780,000, or about \$8,500,000 in terms of amounts eligible for preferential treatment, made up chiefly of consumer manufactures.

6. More generally, it was indicated that the list was drawn up so as to omit "products in which less developed countries are already competitive in world markets," and that "the preferential rates should be subject to modification as producers in less developed countries become competitive."

7. On the other hand, it was also indicated that the items specified constituted an "initial list" and that other products might be added from time to time.

Unless the Australian list were to be significantly expanded, it could scarcely be said to open up major new export possibilities for the less developed countries or to provide a challenging example for other developed countries to follow. Indeed, the positive effect of Australia's action was at least partially offset by another step taken at the same time whereby it informed GATT that, in accepting the new part IV on trade and development, it would not consider itself bound by the provisions under which the developed countries undertook "to accord high priority to the reduction and elimination of tariff and nontariff barriers to products of actual or potential export interest to less developed countries" and "to refrain from increasing tariff and nontariff barriers against such products."²²

The "Brasseur Plan"

Except for the exclusion of Hong Kong from the benefits on certain items, the Australian preferences are available to all less developed countries, broadly defined. In this respect the Australian system appears to be more generous than the "Brasseur plan," with which it has been compared, would be. This plan, named after the Belgian Minister of Foreign Trade and Technical Assistance who made the proposals to GATT in 1963, would entail negotiations with individual less developed countries to determine in each case the products to be covered, the margin and duration of preference, and the quantities eligible to benefit. If the plan were seriously looked upon as applying to most bilateral relationships between developed and less developed countries and to most items of interest in the trade, the amount of negotiation and specification required would be astronomical. Patterson

²¹ From statement and accompanying exhibits submitted by the Rt. Hon. J. McEwen, Deputy Prime Minister and Minister for Trade and Industry, to the Australian House of Representatives on May 19, 1965.

²² From Mr. McEwen's statement of May 19, 1965.

suggests, however, that "this approach had the great virtue to some members of the European Economic Community that it would facilitate their safeguarding the value of the existing preferences to each other and, more important, to the Associated States."²³ It is not clear how valuable these latter preferences are, in fact, to the Associated States—i.e., the former African dependencies of France and Belgium—in view of the extremely low level of their exports of manufactures to the former mother countries or other members of the European Economic Community.

Diverse Policies and Common Objectives

The effectiveness of tariff preferences in opening new markets for the less developed countries cannot be judged in the abstract, but depends on the terms of the preferences in each case. The measures adopted in Australia and those contemplated under the Brasseur plan are not reassuring, however, if taken as a foretaste of the kind of preferential concessions to be expected. Rather, they give point to Prebisch's warning that "it would not be worth facing all the political and other difficulties entailed in a new departure from the most-favored-nation principle simply for the sake of token margins of preference on a few selected products for a very limited period, amounting to little more in toto than a gesture in the face of the immense problems of the trade gap."²⁴ He might have added that, the more selective preferences are by beneficiaries, the more fragmented is the bargaining power of the less developed countries and the greater their economic dependence becomes on particular developed countries.

It is equally true that the gains to be achieved by the less developed countries through the most-favored-nation approach cannot be judged in the abstract. In principle, their bargaining position for obtaining meaningful concessions from the developed countries is strengthened by three considerations. First, the developed countries have, as noted, pledged themselves in GATT as well as at UNCTAD to give "high priority" to the reduction of both tariff and nontariff barriers to the exports of the less developed countries. Second, the need of the less developed countries to increase exports to cover their growing import requirements is widely recognized. Third, the gains from trade between countries with wide differences in factor endowments should be particularly large to both sides.

In fact, however, the Kennedy Round of GATT negotiations seems to have been regarded by the developed countries as primarily concerned with trade relations among themselves, with only incidental benefits to others, and it is by no means clear what will follow to give effect to their commitments to the less developed countries. As far as the United States is concerned, the tariff-cutting authority vested in the executive branch by the Trade Expansion Act of 1962 does not extend beyond mid-1967, and proposals for a new trade program remain to be formulated and approved. In the European Economic Community there seems to be an increasing tendency to look on the common external tariff as a condition for internal unification, while the United Kingdom appears to be mainly concerned with joining the EEC and perhaps more inclined to reduce than to increase its imports from less developed countries.

²³ *Discrimination in International Trade*, p. 361.

²⁴ Proceedings of the United Nations Conference on Trade and Development, vol. II, Policy Statements, p. 38.

Under these conditions, it may be difficult to develop and carry out a common program of action by developed countries to remove barriers to imports of manufactures from less developed countries, whether by the preferential route or by the most-favored-nation approach. The United States and other countries wishing to provide enlarged trade opportunities to the less developed countries may therefore be faced with the difficult choice, noted by Harry Johnson,²⁵ between (1) unilaterally reducing tariffs on items of interest to these countries without insisting on reciprocal concessions by developed countries benefitting under the most-favored-nation principle, or (2) abandoning that principle and granting concessions to the less developed countries only, or to some of them, on a preferential basis compared with the tariff treatment accorded imports from developed countries. The United States would thus have to abandon one of two basic principles—either that of reciprocity or that of nondiscrimination.

Whatever the answer to this last question,²⁶ it seems likely that, viewed as a whole, the trade policies of the developed countries vis-à-vis the less developed countries will continue to be a mixed bag—equal treatment in some sectors and areas and unequal treatment in others, measures to expand trade along with restraints, declarations of good intentions followed by good, bad, and indifferent results. One of the weaknesses of the selective preferential approach in particular is that it lends itself to illusions, by both preference-giving and preference-receiving countries, as to how much has been accomplished. A great amount of paperwork may yield very little trade.

In the face of this prospective diversity and uncertainty, the question arises whether it would be useful to try to make sure that the policies pursued by the developed countries, whatever their form in each case, were consistent with the results aimed at, which would involve quantifying these aims with regard to the levels and rates of increase contemplated for the trade. It may be recalled that Prebisch broached such an idea in his advance report to the United Nations Conference on Trade and Development in 1964, though it was only briefly considered, with little support, at that meeting; that is, that targets be set for developed countries, collectively and individually, with respect to their imports of manufactures from less developed countries.

Possible disadvantages of such a course are immediately obvious. If the targets were set too low in relation to the potentialities of the trade, they would be more of a hindrance than a help to its development. If they were set too high, achievement of the targets could present serious embarrassment to private enterprise economies.

²⁵ "Economic Policies Toward Less Developed Countries," pp. 41 and 239.

²⁶ An indication that the United States was willing to consider some modification of its position against trade preferences was given in President Johnson's statement at Punta del Este in April 1967: "We are ready to explore with other industrialized countries—and with our own people—the possibility of temporary preferential tariff advantages for all developing countries in the markets of all the industrialized countries." (See "Department of State Bulletin," May 8, 1967, p. 709.)

The likelihood of a more specific and immediate step, agreed on with other countries, was indicated in the statement issued on May 15, 1967, by the director-general of GATT in summing up the results of the Kennedy Round. Noting that the tariff reductions agreed on in the negotiations would, in general, be phased over a period of years, he said that the participants had, however, "recognized that, for the developing countries, the immediate implementation of such tariff cuts would be of great value in maximizing the benefits to them of these negotiations." He further stated that efforts to achieve the advance application of the cuts to imports from the developing countries would continue, and that a decision on this point was expected to be reached by the time that the agreement embodying the results of the Kennedy Round was ready for signature. GATT press release, May 17, 1967 (GATT 1990).

Such problems may, however, be more theoretical than real in the present instance. Reasons have been given in chapter II for believing that the forces underlying the rapid growth of the trade from the early 1950's to the mid-1960's may become progressively stronger. If that view is correct, it would probably not be too much to suggest that, by 1975, the trade will again have grown fourfold, or more to something like \$10 billion (at present prices). Higher figures could be envisaged if the enlargement of market opportunities extended to all of the developed countries, including those that so far have lagged behind.

Fulfillment of targets by the developed countries in these conditions would not be a matter of creating artificial inducements but of removing artificial impediments to the trade. Some developed countries might elect to do so by reducing import barriers over the whole range of products of interest to less developed countries and to do so on a most-favored-nation basis. Some others might choose to proceed much more selectively with respect to both the products and the countries benefiting by the concessions. Whatever the method, a set of agreed targets should help to give a common purpose and meaningful content to their actions.

It would doubtless require a good deal of study and negotiations to obtain agreement on a global target for imports of manufactures from the less developed countries that would be both consistent with their growing foreign exchange needs and acceptable to the developed countries. Arriving at an agreed basis for distributing a global target among individual importing countries could well prove even more difficult.²⁷ If agreement were impossible on such an allocation, or even on a global target, the effort should at least serve to direct thinking about commercial policies affecting less developed countries toward results as well as methods and to make it more difficult to generate schemes lacking in effective content.

It would no doubt be more difficult—but also more questionable—to divide up a global import target among individual exporting countries. Too much depends on their own economic situations and policies in each case. The Prebisch proposal on preferences calling for gradation of preferential margins among the less developed countries implies that the ability to export manufactures is positively correlated with their stage of economic development. This must be true in some sense, if one thinks of potential exports. But the analysis offered here has also revealed that, typically, the “more advanced” of the less developed countries, including some that have had preferential access to certain developed countries’ markets, have not done well as exporters of manufactures to developed countries. If, as this experience suggests, the basic difficulty lies in their own economic situations and policies, it would be of little advantage to them, and an unnecessary limitation on other less developed countries’ possibilities, to reserve for them specified shares in a global import target. Even in such cases, however, a more receptive attitude by developed countries toward imports from less developed countries would help to clarify the issues and to encourage policies in the less developed countries conducive to the growth of their exports.

²⁷ Prebisch suggested that the total might be divided up (1) according to each importing country's consumption of manufactures or (2) according to its share in total imports of manufactures from all sources. The first criterion, however, would tend to overstate, and the second to understate, import objectives for large countries with diversified economies and less dependent on imports than small countries with more specialized economies. Prebisch concluded that a combination of the two criteria might yield a formula acceptable to all developed countries (p. 38 of vol. II of the conference proceedings).

EAST-WEST TRADE: DILEMMA OR DELUSION?

BY KENNETH R. HANSEN *

"A little of both" would be the way to characterize this uniquely U.S. issue today. On the one hand, there is a virtual standoff in policy attitudes between the administration and the Congress; on the other, there are exaggerated fears of harm and hopes of gain regarding any significant change in U.S. trade policy toward Eastern Europe.

Overshadowing this issue today as it has in the past is a cloud of self-righteous rhetoric, dire prophesy, and congressional timorousness which too often obscures the boundaries of our legitimate national interest and immobilizes U.S. official, business, and cultural forces which might otherwise be exploring the extent of cost and opportunity which this area holds for the United States in the 1970's.

Paradoxically, although we have persisted in following a highly restrictive trade policy with the Communist sphere for over 20 years, we are not at all sure of the costs and benefits of our prolonged period of self-imposed abstinence from this trade.

Ironically, we know we have paid a high price in increased isolation from and friction with our Western Allies by obdurately pursuing an increasingly divergent trade policy with Communist areas.

Tragically, we are only lately coming to realize that we might achieve affirmative and peaceful purposes by seeking and granting trade opportunity rather than yielding this field of traditional American excellence because of apprehension of unequal benefit or one-sided exploitation by Communist trading states.

Providentially, we now appear to stand on the threshold of change in East-West trade policy.

This paper is intended to probe provocatively but constructively this congested artery of U.S. vital interest in the hope that our East-West trade policy paralysis will yield somewhat to the prophylaxis of plain speaking and while it is not always useful to recount the partially remembered past for fear of redundancy, the overhang of some past attitudes and actions so strongly biases future decision in this area that some retrospective analysis seems merited. To a considerable degree, U.S. East-West trade policy and legislation must be freed of past misconceptions and misconceptions of the past before actions in this field may contribute to our national purposes and objectives of the future.

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I. THE HERITAGE OF THE PAST

PEARL HARBOR, THE COLD WAR, AND M'CARTHY REVISITED

No field of contemporary national policy carries a heavier burden of colorful, controversial, or connotative public utterance tending to coerce attitude and judgment than U.S. East-West trade policy: Scrap iron to Japan, trading with the enemy, strategic commodities, war material, Communist trade, slave labor goods, and Soviet dumping.

From the first overt legislative reference to East-West trade in the act of Congress authorizing the Marshall plan in the 1948-49 period, up to—but not including—the present debate on the East-West Trade Regulations Act of 1966, our official policies, private actions, and public dialogues have been dominated by the emotional reactions and apparent moral connotations of the seemingly perpetual state of East-West tension, hostility, and struggle. As a result there has been little ambiguity of public opinion in the United States during the past 20 years on this issue. And as the cold war has waxed and waned, to be succeeded by Korea, Cuba, and Vietnam in the roster of direct U.S.-Communist confrontations, the public posture of the United States has been steadfastly in opposition to "traffic with the enemy." For most of the period since World War II, therefore, there has existed in the United States a simple two-valued orientation: the Communist bloc was hostile to the West; therefore, trade with the East was at the least unwise—and at worst, treasonable or suicidal.

And, for much of the period, the general thrust of this attitude was justified. Although in many instances public attitudes were exploited and public and press sensationalism and congressional demagoguery were the overreactive concomitants to the more selective and restrained executive actions, diplomatic endeavors, and congressional mandates governing our relations with other countries, it was a fact that Soviet bloc trade policy in the post-World War II period constituted a significant threat to the security of the Atlantic community and other free world countries.

THE 1946-49 PERIOD: THE COLD WAR FREEZE

East-West trade controls, therefore, originated as an aspect of the cold war and have retained for the United States the form and spirit engendered by those times.

A vignette of that period shows the vengeful and illogical industrial dismantling of East Germany and the Soviet zone of Austria by the Soviet armies, partial looting along with political subjugation of parts of Eastern Europe, and the emergence of Communist attempts to penetrate the war-weakened West-European political and economic structures. This dynamic period saw the hardening of East-West distrust and the discord of wartime allied interests. East to West and then West to East, trade and economic intercourse slowly rebuilding in the wake of war was disrupted and most of that interrupted by the war was not actively resumed. In addition, extensive and worldwide networks of Soviet agents, black-marketeers, and international adventurers engaged in all manner of illicit dealings in so-called strategic trade items from West to East.

Systematic attempts were made and often thwarted—to ship strategic and short supply items from Western Europe to the Soviet and satellite economies. As a consequence, the press was liberally festooned with disclosures of allegedly enormous illegal trade in precision instruments, ball bearings, critical and precious metals, prototype and production machine tools, and other items deemed strategic in nature.

In countermeasure, West-East trade control programs were formulated—initially by individual countries, and later by the soon-to-be-designated NATO countries in the Coordinating Committee (COCOM). First—to place embargoes and quantitative controls on items deemed strategic, and then to strengthen defense against illicit trade in the form of transshipping, mislabeling, smuggling, false invoicing, and other devices.

As these Western trade control programs evolved, they became increasingly militant and far reaching. The proposal and adoption of restrictive measures were virtually unanimous among the Western allies and Japan. It was in the spirit of the times—the NATO buildup, the Greek Communist insurgency, the Berlin blockade, the Italian and French Communist election crises. East-West restrictive trade policy developed as a measure of resistance to Stalinist aggression and the strategic control program evolved to become an active element of the containment strategy.

In these circumstances, the definition of strategic materials did not constitute a difficult task; there was a presumption that most industrial items for which there was demonstrated demand by the Soviets were ipso facto of some strategic importance. Similarly, any large quantities of metals, minerals, or scarce commodities were considered to be of value to a war machine poised for potential aggression. And finally, even so-called peaceful goods such as textiles or consumer goods or agricultural products which might conceivably free up manpower for the military, or permit reallocation of key resources elsewhere were popularly viewed as contributing to the warmaking capability of a potential enemy—the so-called fungibility principle.

It is of major relevance that this combined selective and complete embargo policy was compatible with other strategic circumstances of the times as well: East-West trade was being conscientiously throttled by a Stalinist drive for European Communist bloc political and economic hegemony, and Western Europe was going through a tremendous effort at economic reconstruction which served to place a comparable scarcity value on the so-called primary strategic industrial goods.

Thus, born of necessity and consonant with political policies and economic circumstances, controls on trade with Eastern Europe and Communist China were both a talisman and an instrument of Western unity in the face of Communist hostility and aggression.

THE BIRTH OF CONGRESSIONAL "OVERKILL"

There emerged in this initial period several other concepts, however, which achieved unwarranted currency in thought and action in the United States, and subsequently contributed to friction and disunity among the Western countries. One of these was the rather crude device embodied in U.S. legislation of indicating to Marshall plan and other U.S.-aid-recipient countries that if they didn't refrain from

trade in "strategic" materials with the Sino-Soviet bloc, all U.S. military and economic assistance would be cut off to them. The list of strategic items, moreover, was to be determined arbitrarily by the United States, and (until executive branch protestations prevailed) action to cut off aid was intended by the congressional authors and supporters of the legislation to be automatic and irrevocable. After bitter battles over the so-called Kem amendment to the pending foreign aid legislation—there was a compromise whereby action to discontinue aid must be taken in the case of shipment of designated atomic energy and military items (arms, ammunition, and implements of war)—but aid could be reinstated if the President deemed that the offending nation would thereafter comply with the embargo. Or if the items were of a "primary strategic nature" the President could continue aid if he determined that the discontinuance of aid "would clearly be detrimental to the security of the United States."¹ These provisions remain in controlling legislation up to the present day—but attempts to remove or diminish Presidential discretion have been numerous in the troubled years of this program up to the present.

In many sectors of U.S. public and congressional opinion, the Western European countries trading modestly in this period with the European bloc and Communist China, were variously held to be profiteers, ingrates, or foolishly insensitive to the threats of the worldwide Communist conspiracy. Particular criticism was leveled against the British—heighted because of their additional involvement in East-West trade through their extensive worldwide shipping—and against the West Germans, considered to be hedging their bets against possible Communist takeover of Central Europe. Considerable apprehension was volubly expressed concerning the alleged hunger of the Japanese for a trade rapprochement with the vast potential market of Communist China. And as major potential East-West trade exchanges of a compensation transaction and barter nature were bandied about in the international press—considerable anxiety was felt regarding possible overdependency of this or that Western country on the Soviet bloc as a source of supply or as a market. There was, in short, an atmosphere of suspicion on the East-West trade issue between the United States and the European countries * * * and this was conclusively embodied in U.S. legislation from the very outset.

A third aspect of congressional oversight—which happily has not persisted to the present day—related to the administrators of the trade control programs themselves. At a very early period, the economic warriors of the United States were sometimes extolled as sterling characters who ingeniously thwarted the devious designs of the Soviets and exposed their worldwide machinations. At a later period—especially during the reign of terror of Senator Joseph McCarthy—many of these same people became suspect security threats or alleged fellow travelers or Communist dupes if they (or the administration) showed any possible weakness in fervor and effectiveness, or took a policy stand on East-West trade other than of uncompromising opposition. These circumstances doubtlessly had some influence on the persistent rigidity of policies in this field up to the present time.

¹ Defense Assistance Control Act 1951—title I (Battle Act).

THE 1950-57 PERIOD: THE GROWING DIFFERENTIAL IN CONTROLS

This period—ushered in by the Korean conflict—initially saw a high level of control, and a reasonably high degree of agreement between the allies regarding the necessity and value of trade controls.

It was during these years, too, that controls over free world shipping—especially that engaged in the China trade—became a major element in U.S. international trade relations. “Flag of convenience,” neutral country and long-term allied ship charter to Sovbloc nations and Communist China became the target of U.S. diplomatic pressure. During the Korean conflict these problems became especially acute and, in general, U.S. efforts were successful in stemming the involvement of free country shipping in intrabloc trade. Little impact, however, was made on western shipping engaged in carriage of so-called “peaceful” goods to Communist China and this led to unilateral U.S. measures such as bunkering controls, denial of use of U.S. ports and blacklisting of vessel fleets of a common owner from participation in U.S. Government financed cargoes—especially foreign aid.

These latter types of restrictive measures were short lived and largely related to the Korean struggle. In most respects they were psychological in their intent and impact; they had relatively little effect on intrabloc goods movements. Nevertheless, they were considered an appropriate adjunct to the military measures being undertaken in Korea in response to Communist aggression (a similar situation to that of North Vietnam today). It is noteworthy, however, that even in the wartime circumstances of those days there was western unanimity only as it related to denying Communist China strategic materials and war materials on a longer list than that multilaterally agreed for denial to the Sovbloc in Europe. No other major trading nations have followed the U.S. policy of virtually complete trade and financial embargo of Communist China which still exists in full force today because of the persistence of Chinese hostility, vituperation and aggression.

As noted earlier, this period was further marked by the traumatic effect of McCarthyism on U.S. foreign affairs—initially related to China trade and later more broadly addressed to terrorizing the U.S. political countryside. This was widely held by the Europeans to have contributed to a “freezing” of the U.S. position on East-West trade controls, and immediately following the Korean war there was soon evidence of a deep and growing official difference of outlook between the United States and the Western European countries and Japan regarding the necessity, utility or relative effectiveness of controls on trade with the Eastern European countries and the U.S.S.R. The fact that this was coupled at the time with Soviet blandishments of large purchase orders and seemingly tempting markets made for even greater strain. And in 1953-54 the Europeans—led by the United Kingdom and France—literally forced a severe retrenchment in the scope and severity of agreed multilateral controls on trade with the European Soviet bloc. In effect, they challenged the purpose and scope of the embargoes and asserted the potential positive value of expanded trade in nonstrategic goods. And this “trade policy gap” which developed between the United States and Western Europe was soon broadened into a “strategic controls gap” since formal U.S. unilateral controls still extended far beyond the diminishing multilateral level—

heralding the polarity of other East-West political objectives and approaches yet to come. In this connection it is important to note that, whereas the action taken was to decontrol various so-called strategic items, the assertion by the NATO countries and Japan² was that it was important to liberalize trade as an instrument of positive policy in dealing with the Soviet bloc in the post-Stalin period.

1957-66: THE GROWING DIFFERENTIAL IN CONCEPT AND PRACTICE

Strategic Trade

The trade control gap between the United States and CoCom countries became wider throughout this long period. The differential level of multilateral controls regarding trade with Communist China and North Korea was rescinded in the multilateral strategic control program in July of 1957 although the United States, as noted, still maintains complete embargo. In 1958 another substantial revision (freeing-up) of the CoCom embargo list took place, without any substantial impact on U.S. unilateral policy. And while there were several subsequent additions and redefinitions of the lists, in each instance these actions have represented a tacit recognition by the United States that further agreement to a strict control level by the CoCom countries was not possible and that the shared scope of strategic controls would soon not extend beyond the obvious war materials and some of the new and more exotic industrial and scientific hardware and technology.

Such has indeed been the case—there has been constant net attrition and “updating” of the strategic lists. The multilateral definition of strategic has shrunk and become more concentrated on a concept of assuring a lag in technological development in fields related to modern warfare, in space missile and nuclear applications especially. Concepts of impairment of economic growth of the U.S.S.R. and the Eastern European countries by denial of general industrial exports has long since been abandoned. And denial of trade in hopes to cause economic disruption, greater cost of production, or inconvenient reallocation of resources in the Communist economies are no longer criteria which govern the multilateral program.

On this basis, much of the present-day multilateral activity revolves around discussion and consultation regarding individual strategic trade problems. Orders of large magnitude by the U.S.S.R. or the other eastern countries for items of generally known end uses, such as the FIAT auto plant, large diameter oil pipelines, transportation equipment, special machine tools, et cetera are debated and dealt with on a case-by-case basis.

Meanwhile, the trade the West Europeans and Japanese carry on with the Communist areas has become wider in scope and greater in magnitude. And the marginally greater permissiveness of recent changes in U.S. export policy has not altered this disparate trend.

General Trade

This brings us to the fundamental East-West trade phenomenon of the past decade. Free world exports to Eastern Europe including the U.S.S.R. have risen steadily from a low point of \$1.1 billion in

² The CoCom countries.

1950 to \$4.8 billion in 1963, to about \$6.2 billion in 1965. Imports have roughly kept pace: with \$1.2 billion in 1950, \$4.8 billion in 1963 and \$6.3 billion in 1965. Of this, our CoCom partners have generally accounted for more than half.

U.S. trade, on the other hand has been relatively stagnant over the same period at a level of between \$130-180 million of exports and roughly \$120-130 million of imports. (In 1964 we sold \$259 million worth of surplus agricultural commodities to push our 1-year total to \$340 million of exports versus \$99 million of imports, but this has not been repeated.)

The overall East-West trade development picture, while apparently dynamic, has not been a runaway situation by any means * * * in the 5 year period 1961-65, total free world trade with Eastern Europe increased by 49 percent, while free world trade with all countries increased by about 40 percent. And today, East-West trade only accounts for about 3 to 4 percent of the total trade of Western countries. Paradoxically, in spite of early fears of possible dependency of Western countries on the bloc, trade with the West now plays a relatively more important role in the economies of various of the Communist countries.

The U.S. share of this large and growing market, however, is barely 3 percent—extremely narrow in products exchanged—and declining in relative terms.

Obviously, this disparity of general trade has not been largely or even significantly the direct result of our differential strategic materials control policy. It is partly the result of many circumstances encountered naturally as obstacles to trade between the market economy of the United States and the state trading economies of Eastern Europe. It is the result of a lack of credit, financial and other aid to bring about enlarged exchange of goods and services. It is partly a consequence of the lack of mechanisms of advertising and supply and distribution and cross-servicing. There are many technical and objective barriers to expanded United States-Soviet bloc trade. But principally the relatively small volume of trade has been the result of the negative thrust of U.S. national policies regarding East-West trade—amply reinforced or occasioned by public and congressional opinion vociferously against trading with the Communist areas of the world.

The only significant breaks in these policies have been the hard-fought exceptions won by successive administrations from a grudging Congress: (i) to permit more liberal trade and credit support for Yugoslavia in 1949; (ii) Public Law 480 credits to Poland in 1957 and subsequent years; and (iii) the precarious year-to-year and on-and-off extension of most-favored-nation (MFN) treatment to be accorded imports from Yugoslavia (1951) and Poland (1960). The other steps in this direction have largely been by Executive (Presidential) initiative in ways not requiring congressional ratification—but also virtually without congressional encouragement.

In the past four years these actions have been numerous—Johnson Act credits, extension of Export-Import Bank guarantees to several Eastern European countries, liberalization of trade with Rumania, and most recently the decontrol of a number of items from the general license list of the Department of Commerce.

The current culmination of these actions, of course, is the proposed East-West Trade Relations Act of 1966 now pending before the Congress.

SOME CONCLUSIONS

Before going into the new issues and future prospects of policy in this field, it is useful to evaluate further some of these past developments. While the record of the past is incomplete and far from clear—I believe it is possible to make some judgments which are relevant for future policy and action in this important and controversial field.

The hard facts appear to be these:

1. The initiation and active development of East-West trade controls in the Stalinist and Korean periods were appropriate to the circumstances of the cold war, complementary to our foreign policies, and contributory to our security objectives.

2. Since this was a critical period in the relative growth of economic and military potential of both areas—Western Europe and the Soviet bloc—and Western Europe had the United States to rely on as a source of capital, advanced technology, and industrial plant and markets, there is little question that, with its smaller and less advanced industrial base, the European Soviet bloc would have been greatly helped to have had greater or free access to Western supplies and markets.

3. In some respects, however, this was denied as much by the Soviet drive for bloc economic hegemony and the other natural obstacles to expanded trade inherent in the state trading system—as well as the self-imposed political isolation of the bloc—as it was by the multi-lateral trade control program.

4. Thus, both the strategic controls program and the mutual discouragement of trade probably worked to the relative economic-military advantage of the West, although this period was used behind the Iron Curtain for pursuing political and economic consolidation of the Eastern European countries and the isolation may have been a mixed blessing for the West in this respect.

5. The wide gap that has developed between the United States and the other Cocom countries from the period of the mid-1950's to today in the area of strategic trade controls has been vexatious and has exacerbated relationships among the NATO allies from time to time. These differences have not been judged to be a threat to our security, however, even though the availability of machinery and equipment from these countries offsets substantially the more extensive denial of these items by the United States.

6. In any event the additional restrictions in so-called strategic trade with the U.S.S.R. and Eastern Europe which we specifically impose today in isolation from our friends and allies must be judged to have long since ceased to have material significance to the military and economic potential of the European Soviet bloc.

The utility of the differential in the strategic trade controls can be challenged on two grounds: (i) Whether in fact, unless available solely from the United States the Soviet bloc cannot readily obtain U.S. proscribed exports from elsewhere in the free world, and (ii) whether the Soviets, generally self-reliant as they are, are truly affected by the denial in any case.

The justification most often advanced is that were it not for this differential, the West Europeans would relax the trade even further (they ship very few of the contested items in any event)—and since these are largely items of advanced technology, the United States has some other means to limit their sale to the East through end-use control over components and technical data control and private industrial cooperation.

The burden of these arguments are not, and need not be, to pare our lists of strategic items to the Cocom level. It is far more important merely to realize that maintaining this differential does not necessarily serve our national interest in any truly effective manner—and that we seriously err if we insist that the disagreement of others is not genuine—or is occasioned by the alleged opportunity to profit at the expense of our higher standards of trade morality and greater sensibility to security interests.

The discussions, analyses and attempts at reconciling views about strategic list items have gone on with our European allies and Japan too long and with too great sincerity to merit that suspicion and disdain. We shall probably have to just accept the fact that there is disagreement on this range of items. Similarly, we shall have to accept the fact that as the economies and technological prowess of the U.S.S.R. and the other East European countries grow—along with their military capabilities—it will be harder still to identify items which would be sought by them in overt trade which will have apparent direct relevancy to Soviet bloc military potential. Our NATO allies and Japan are not disregarding strategic considerations in their trade dealings. They do, however, take the view that selective denial is in any case extremely uncertain as to effectiveness and almost hopeless to maintain indefinitely in the face of technological progress the world over. In effect, they question—as we must—whether these measures are not so extremely marginal in their possible present and future effect on the relative strengths of East and West as to be almost inconsequential.

Finally, we should also realize that as we appear to have gained little in a substantive sense by our insistent and isolated posture, we similarly have often made it more difficult to obtain the understanding, agreement and cooperation of our friends and allies on other policies and programs when our apparent and prolonged intransigence in this field is of related consequence.

7. This brings us to the point of real disparity and difference which has existed between the United States and our free world friends. That is, the basic difference in general trade policy vis-a-vis the European Soviet bloc.

This difference has been based largely upon U.S. political and foreign policy and public opinion considerations not shared in extent or degree by most other free world countries. It is exemplified and underscored by the fact that in the 1961–65 period alone, there has been an exchange of goods and services between the free world and the Soviet bloc of an aggregate of about \$51 billion—\$25.4 billion exports and \$26.2 billion imports. Of this, somewhat over half was CoCom country trade. And for the same period, total United States-Communist bloc trade was \$1.4 billion (\$906 million exports; \$496 million imports).

This growing trade gap, rather than the strategic controls disparity, is the key policy consideration today.

8. Admittedly, this nonstrategic trade is limited by factors other than trade policy. Foreign exchange shortages, lack of established channels of trade, inadequate or inappropriate distribution methods, packaging, servicing, high duties, and other circumstances inhibit the Communist trading capabilities with the United States. Lack of marketing contacts, credit arrangements, uncertainty as to business arrangements, fear for adverse public relations and other obstacles occur on the side of U.S. business. But generally, the public U.S. posture has been predominantly in opposition to expanded trade for fear of giving unequal benefits through such trade to the communist areas.

9. Positive actions to change these circumstances and attitudes have been generally lacking on both sides—the United States and Eastern Europe—and steps have only recently been initiated by either side with any credibility that the actions might literally “mean business.”

As noted earlier, however, most of these actions to encourage U.S. nonstrategic trade with Communist areas have been undertaken on the U.S. side by Presidential initiative—and largely in the absence of any congressional mandate. Almost all existing legislation in the field of East-West trade or pertaining thereto is based upon the cold war ethic: the Battle Act, the Export Control Act, the Foreign Assistance Act—and a motley crew of riders to annual appropriation bills and food-for-peace program.

10. The latest action of the administration—the proposed East-West Trade Relations Act of 1966—is an effort to obtain congressional sanction for a different policy approach to East-West trade, and to change the heretofore predominant sentiment in this area from one of moral outrage to at least one of acquiescence.

11. Given the long, controversial, and single-valued history of U.S. East-West trade policy in the past, and current resentment of Eastern Europe's trade with Cuba and North Vietnam, this will be a difficult task. Here again, however, the test of any ancillary policy is the requirement that it further the overall objectives and strategies being pursued in the national interest; East-West trade relations are an integral part of our foreign policy. And the manner in which East-West trade relations are managed in the decades ahead clearly must be more affirmative and daring than in the past if a positive contribution is to be sought.

II. THE ISSUES OF THE FUTURE

The initial debate regarding the specific aspects of the administration's proposed East-West Trade Relations Act of 1966 is already a matter of congressional record. Its main provisions are clear in concept and intent:

To use peaceful trade as a means of advancing the long-range interests of the United States.

To authorize commercial agreements with a Communist country when the President determines—

It will be in national interest.

It will result in equivalent benefit to the United States.

To authorize the President to confer most-favored-nation (MFN) treatment for Communist countries' imports as part of the commercial agreements—subject to periodic renewal—and subject to withdrawal if no longer warranted.

As such, this proposal symbolizes a proposed new formal dimension of East-West relations: an opportunity approach to trade and political relationships with individual East European countries; a recognition that possibilities for expanded East European trade with the United States will require special commercial arrangements; an acknowledgment that access to our market must not be discriminatory if trade is to flourish; and finally, while the proposed bill signifies no change in the other safeguarding legislation which up to now tended to govern both the letter and spirit of U.S. policy in East-West trade, it is clear that this legislation calls for a new direction in trade relations with Eastern Europe and the U.S.S.R.

There are, of course, certain issues related to the specifics of this legislative proposal, but it is not necessary to go into these here. They will be subject to detailed scrutiny in the follow-on hearings. Rather it is important to go behind the proposed change in overall policy and to consider the underlying questions and issues which arise regarding a possible expansion of peaceful U.S. trade with Eastern Europe and to consider finally how this may relate to other world problems and the U.S. role in dealing with them.

INCREASED EAST-WEST TRADE: COST/BENEFIT

Given the security context in which this question is inevitably viewed, the first question is: Will it be possible to bring about an expansion of peaceful trade without reducing U.S. strategic trade controls?

Earlier the point was made that these controls are not the real barrier to expanded trade. In fact, very few of these solely U.S. proscribed items are proposed for export, and thus, few licenses are denied. More practically, however, the controls do not cover such a vast range of items so as to seriously inhibit a wide choice of goods from this country if there indeed were a determination to expand peaceful trade.

There are other ramifications to this question, however; these have to do with the attitudes of the Soviets and the Eastern European countries themselves.

The first is whether they would choose to make an issue of the more extensive U.S. denial program in the negotiations regarding commercial agreements. Past exchanges with the East Europeans and the U.S.S.R. have indicated that these measures constituted somewhat of a "bone in the throat" in relations with the United States. But, by the same token, in the trade arrangements with other Western countries, the strategic control programs have not been at issue to the extent of seriously interfering with the growth of peaceful trade.

Second is whether the Eastern countries will believe in United States sincerity and willingness to expand peaceful trade if there is apparent continued U.S. militancy in maintaining a much higher level of strategic controls and continual striving to have other free world countries do so.

Fundamentally, it would appear that maintenance of this differential will not be a major obstacle to expanded East-West trade unless either side chooses to make it so.

The major question then asked regarding a change in U.S. trade policy vis-a-vis Eastern Europe, of course, is whether increased trade with the United States will tend to strengthen the military-economic system in the Eastern European countries.

The answer is "yes." And the answer will always be "yes" unless someone has invented a way to bring about an exchange of goods and services and information where the benefits bestowed will accrue solely to one party to the exchange—or, where the exchange is so particularized or minuscule as to be devoid of any meaningful economic impact.

Obviously, trade must be mutually beneficial or it will not take place between two parties who have the power of consent or denial. And as long as a significant portion of the total resources of the Eastern European countries are allocated to armaments and armed forces, anything which materially affects the output and use of those resources will strengthen that area in some degree as well.

The critical question then is: Will the Eastern Europeans and the U.S.S.R. obtain gains or benefits from an expansion of nonstrategic trade with the United States which outweigh the possible benefits sought to be obtained by the United States? Or the corollary: does the United States now stand to benefit more by a continued denial and discouragement of trade in nonstrategic items, than by a policy of developing and encouraging such trade with Eastern Europe?

A changed official, public, and congressional attitude on these questions constitutes the major hurdle which the new U.S. initiative in East-West trade policy must clear. And if the case is to be made, it will require a steadfast belief that the political gains from such a policy will be more real and meaningful than the apparent tangible contribution which might be made through increased trade to the growth and power of Communist Europe. In effect, increased political opportunity and the possibility of accelerating the processes of peaceful change in the Communist areas is considered the crux of the matter, and this is looked to offset the small potential benefits which the Communist areas might derive from encouragement of higher levels of trade.

For one thing, it must be made clear that the genesis of this policy change is to be found in the changing objectives, strategies, and intent of overall U.S. East-West policies; and, for another, the hoped-for outcome of a change in East-West trade policy is not only a new and larger pattern of two-way trade, but a new and more hopeful pattern of political and economic relationships between the United States and the nations of Eastern Europe and the U.S.S.R. This is the basic proposition underlying the new approach; a change in U.S. East-West trade policy is being pursued primarily as an avenue to peace—rather than as an adjunct to defense or in hopes of commercial gain.

It is necessary, I feel, to pursue this question more fully at this point—even before considering whether, in fact, U.S.-Eastern Europe nonstrategic trade can be appreciably increased. The reason for this is simple: it will indeed be difficult to increase such trade—and the perceived political benefits must be very apparent before we will be pre-

pared to undertake the kind of efforts and make the kinds of concessions necessary to bring about meaningful increases in peaceful trade with the Communist countries.

WIN-LOSE: OR, WIN-WIN?

Heretofore, we have basically applied a "win-lose" calibration to our East-West trade policy and many of our relations with the Soviet bloc. By this arithmetic, since the Soviet bloc was a somewhat industrially retarded and semibackward adversary in the economic-military competition between our two worlds, trade which would somewhat strengthen the growth and increase the national income of the Communist countries was to be generally avoided even though this similarly denied the west the additional outlets and sources of supply for burgeoning production and demand. As noted, this logic fitted consistently with past times and events, both practically and politically.

As the practical aspects of this have changed—and trade denial has become of marginal importance as a defensive measure—greater nonstrategic trade has developed and the political climate has been changing as well. And if the past United States aloofness or hostility to nonstrategic trade has been judged to be largely ineffectual in the strategic sense, what, then, must be asked is the balance of political benefit which increased trade might bring?

It is not difficult to judge that, considered alone, a greater exchange of goods between the United States and Eastern Europe and the U.S.S.R. would bring apparent economic benefit to the eastern countries; there is great diversity, economy and technological content to the manufactures and industrial and consumer goods we provide from our large and efficient production base. And while these items in greater quantity would probably not make a major impact on economic growth and development of the Eastern European economies—expanded trade per se would be of considerable benefit to the Communist areas. In fact, of course, this is already true with regard to existing nonstrategic trade by Western Europe and other free world countries today. The economic quid pro quo for us would be of more general and pervasive nature—largely associated with cost factors related to alternative sources of supply, economies of scale and greater competitiveness of exports, some possible contribution to the balance-of-payments picture, and the diffuse economic benefits of a slightly higher level of economic activity engendered by foreign trade—all very small when considered in comparison with our total trade picture and growth of GNP.

One might judge from this that if some increase in general world trade could take place elsewhere without major political implications, the United States should be highly indifferent to an increase of trade with the Communist areas—and could as well choose to concentrate its efforts elsewhere. In other words, by the "win-lose" test, there is little point in adopting an affirmative policy toward nonstrategic trade with the Communist areas when we might address the same efforts to improving the level of trade with other parts of the free world. Besides, the West Europeans and Japan as well as other free world

countries are doing very nicely, thank you, in reciprocal trade exchanges with the Communist world, and are not having the trauma of internal and external political dissent which we generate on this issue.

Obviously, the calculus of judgment is for us to become convinced that the previous dismal arithmetic of "win-lose"—with U.S. security presumably the loser—can be transformed into "win-win" where there is at least equivalent benefit, and that this benefit can be reciprocal politically as well as economically.

The administration's thesis behind advocacy of a change in U.S. East-West trade policy is essentially that an increase in nonstrategic trade and attendant commercial, diplomatic and other contacts will contribute to the pursuit of peace between otherwise hostile camps. By this thinking, it is asserted that either increased or diminished trade in nonstrategic items can today hardly prove critical or even very important in East-West economic or military relationships; whereas it is possible that increased trade and contacts may serve as a creditable and effective accompaniment to sincere and genuine efforts to bridge differences and resolve conflicts and create a new avenue for seeking East-West understanding.

The implication of this thesis, it must be added, is also that the increase of U.S.-Eastern European trade should not be passive—but should be pressed as a positive element and "instrument" of our foreign policy.

This total concept is now embodied in the administration's proposal now pending before the Congress: the draft statement of purposes reads " * * * to use peaceful trade and related contacts with Communist countries * * * to promote constructive relations * * * to increase peaceful trade and related contacts * * * to expand markets * * * in those countries by creating similar opportunities * * * to compete in U.S. markets on a nondiscriminatory basis."³

The President has clearly indicated that a change in East-West trade policy is a corollary to his other efforts toward "building bridges" to and with the Communist areas.

There is little question that vast changes have occurred and are now in progress in the Communist world that are favorable to our interest—and that we should seek to reinforce and promote the processes of change. Most of these changes are well known and documented: the shattered Moscow-Peking axis, the loosening hold of Moscow over some of the East European countries, the increasing independent initiatives of these countries in their relations with each other and with the West. There has been an opening up within the Communist societies as well—less obvious uses of police power, growing contacts with Western people, greater travel possibilities, and the much more extensive preoccupation with economic reforms, criticism of Communist systems and values and inefficiencies, and somewhat of a retreat from centralized controls and rigid ideological disciplines.

It is this accelerated process of change which provides hope that enhanced economic intercourse and personal contacts and more extensive diplomatic probing for common interests might reduce the chances of hostile actions and confrontations between the United States and the European Communist sphere.

³ Proposed East-West Relations Act of 1966, sec. 2, statement of purposes.

INCREASED TRADE: HOW?

This brings us to the other major aspect of this policy change: what are the prospects for an increase of trade?

There are many difficult aspects to the engineering of a greater flow of trade between the United States and the Eastern European countries. The most fundamental involve:

1. Providing greater access to the U.S. market, principally by modification of U.S. tariff restrictions on imports (most-favored-nation treatment already being sought in pending legislation), improved and more extensive consular relationships (in process), and commercial agreements facilitating elements of contractual relationships (authority being sought).

2. Encouragement and support for U.S. efforts to penetrate and develop the Eastern European markets, including:

Modification of export controls (some action recently taken);

Support of U.S. trade missions and trade exhibits (could be substantially stepped up);

Extension of credit facilities and guarantees (partially undertaken on normal commercial terms);

Development of better means for personal and business contacts and relationships.

Most testimony by trade experts indicates that, even with active promotional efforts and vigorous attempts to remove various barriers to greater two-way trade, the best that can be foreseen is an annual level of trade of perhaps a modest \$500 million within several years. This estimate is based upon general premises, however, which need not hold indefinitely for the future. First, that the extension of commercial credit will be very restricted; second, that the exchange will continue to be in strict balance; and finally, that shortage of foreign exchange holdings and lack of capabilities for earning more by the Eastern European countries will prove a severely limiting factor to an expansion of trade with the United States.

If, indeed, an expansion of direct United States-Eastern European trade is deemed beneficial by both parties and reasonably facilitated—there is no reason to believe that trade preference for U.S. products might not arise in Eastern European nations as it has with many other countries—in spite of other free world competition. Similarly, there is no compelling reason why the rigid pattern of rigorously balanced exchanges between the Communist nations and Western European areas need be maintained forever. In fact, an eventual three-way trade and payments development would appear a more logical pattern than the present—with West Europe importing relatively more from the East, the eastern countries buying relatively more from the United States and the usual increases in United States demand for West European exports completing the circle. Obviously, this change would take some doing—but it would be consistent with the avowed purpose of bringing the eastern countries more fully and freely into the world trading community. In this case, one could wish that the essence of the political argument supporting a change in policy would be more consistent with regard to the expected or desired economic outcome of such a policy. Many of the exponents of the proposed change in United

States east-west policy appear to be somewhat avoiding the implications of success—at least at the economic level. One must, it seems to me, set the economic sights as high as the political—and an early target of \$1 billion annual trade would be more in keeping with a healthy level of economic interchange between these two vast marketing areas.

In other words, we should not expect very substantial and affirmative results from policies which are carried out haltingly and almost grudgingly. If the gains are indeed worth the risks, we should not run the added risk of suffering inadequate results because of halfhearted effort.

It is in this area of expectation and disappointment, too, that another feature of the political argument must be touched upon.

TRADE AS AN "INSTRUMENT OF POLICY"

Already we have found creeping into the debate on future East-West trade policy, a manipulative if not an aggressive overtone which may ill-serve the formulation of policy in this field. In contrast to the "little old ladies in tennis shoes" attitudes of fear and moral outrage which often dominated earlier discussion, we hear increasingly the view advanced that peaceful trade is the next best thing to James Bond for the political subversion of the Soviet bloc and the overthrow of worldwide communism. According to this view, for example, greater U.S. trade and commercial intercourse with Eastern European countries would not only permit the economic benefits of greater access to their markets and greater export earnings for the United States but the new and prolific East-West contacts engendered by this will vigorously fan the latent fires of European nationalism, cause irresistible yearnings for capitalistic affluence, quicken the urges for political freedom by the broad masses behind the Iron Curtain, and subvert and transform the Communist system in short order.

Now, this admitted burlesque of an often sincerely expressed rationale of expanded East-West economic interchange is not to deny or decry some of the expectations of what might ensue from a change of policy—marginal, indirect or remote as these developments may be. The point to be exposed is that—if a straight "win-lose" political calibration is also applied to a change in a trade policy—not only may there be extreme disappointment and disillusionment, but increased East-West trade may be discredited for those purposes it can legitimately serve—whereas the other results it may only incidentally or indirectly promise.

The principal factor to be judged is whether increased East-West trade will contribute to peace—to its development, and to its maintenance.

As an aggressive "instrument of political policy," trade is not a very sharp or lethal weapon. Two-way trade is a channel or conduit of goods, services, knowledge, and personal and official contacts. Expanded trade will serve to increase the plurality of international exchanges—and it is an area where there can be struck a balance of perceived benefit to both parties. In international negotiation it has already been demonstrated that principles of reciprocity are increasingly being perceived as problems of attempting to match demands

and concessions on otherwise unrelated matters in order to strike bargains. And it is in this role—as a springboard of discussion and a medium of exchange—that expanded trade and personal and commercial contacts may contribute to a more hopeful East-West dialog.

If this is so, expanded trade may indeed “fan the winds of change,” but we would be foolish to expect or demand that it also fan the winds of insurrection, subversion or disaffection. Our national interest to be served by a modification of our trade policies as addressed to the European Communist nations will be to reinforce and promote processes of change which will make them less a threat to peace and their regimes less enemies of individual freedom.

Changes are indeed taking place in these areas—major political, social and economic change—even as they are in free world societies. And trade can be a major and positive force in both spheres and between both spheres to increase the possibility of developing cooperative efforts and peaceful pursuits. But it is not a panacea—just as it is not a dread one-sided threat to our security.

THE BROADER INTERESTS

Much of the preceding discussion has been somewhat artificially limited to consideration of U.S. trade with the Eastern European countries and the U.S.S.R. It is clear that an expansion of peaceful trade between these two areas will not take place in a vacuum—without regard to the policies and actions of other nations and certainly not without regard to their political, economic and competitive interests.

In fact, it is in this international and multilateral area—perhaps more than the bilateral—that more rapid progress may be made. As East-West trade becomes larger and progresses even further from the primitive bilateral stage—there will be need to develop better systems of reciprocal dealings and clearings and adjustments. The state trading nature of the Communist countries—which renders some of the traditional bargaining and safeguarding elements of reciprocity in free world trade inappropriate, unenforceable, or unreliable—will have to be changed to accommodate the legitimate needs of western commercial practice. An entire range of new undertakings will have to be worked out: arbitration procedures, protection of patents and other property rights, settlement of financial claims, agreed principles and objective criteria to govern and judge potential market disruption and dumping. In the final analysis, the Communist nations will have to seek ways to remove commercial obstacles arising from differences in their economic systems just as Western countries have adjusted to one another.

With proper authority and flexibility granted the President, the United States will be able to become a major factor in bringing this about—not alone, but in concert again with its other trading partners. As the United States and the Common Market countries and the UNCTAD countries have found it necessary and advantageous to be members of international financial and trade organizations and adherents to international agreements such as GATT—so, in fact will the Eastern Europe countries, if they seek meaningful increases in peaceful trade. Some sort of multilateral machinery—whether in the form of altered or broadened existing organizations—or newly created

ones, will be needed to overcome the limiting features of present day East-West bilateral trade relations. And while the United States has not heretofore expressed interest in or exerted leadership to bring such developments about, under a changed East-West trade policy this will be one of the logical next steps to be taken.

It is noteworthy that this change in U.S. policy is proposed to be undertaken in the dawn of a new trade era in the free world—shortly following the formulation of the Common Market and the major and comprehensive trade overhauls of the Kennedy Round and coincident with greater recognition of the need to concentrate on the other enormous trade gap—that between the developed and less-developed countries. Perhaps this new era may see East-West trade as a major vehicle for political change as well.

In final judgment, therefore, East-West trade need be neither a dilemma nor a delusion for the United States, but we must be more forthright and mature in our judgments regarding this field. Too much is at stake to take sole counsel of our fears as we have in the past; too little is to be gained if we do not act in confidence that genuine efforts toward peaceful relations will be reciprocated.

