2 . INTERNATIONAL TRADE AND WTO

2.1. THEORY OF INTERNATIONAL TRADE

International trade is exchange of capital, goods, and services across international borders or territories. In most countries, it represents a significant share of gross domestic product (GDP). While international trade has been present throughout much of history, its economic, social, and political importance has been on the rise in recent centuries.

Industrialization, advanced transportation, globalization, multinational corporations, and outsourcing are all having a major impact on the international trade system. Increasing international trade is crucial to the continuance of globalization. Without international trade, nations would be limited to the goods and services produced within their own borders.

International trade is in principle not different from domestic trade as the motivation and the behavior of parties involved in a trade do not change fundamentally regardless of whether trade is across a border or not. The main difference is that international trade is typically more costly than domestic trade. The reason is that a border typically imposes additional costs such as tariffs, time costs due to border delays and costs associated with country differences such as language, the legal system or culture.

Another difference between domestic and international trade is that factors of production such as capital and labour are typically more mobile within a country than across countries. Thus international trade is mostly restricted to trade in goods and services, and only to a lesser extent to trade in capital, labor or other factors of production. Then trade in goods and services can serve as a substitute for trade in factors of production.

International trade is also a branch of economics, which, together with international finance, forms the larger branch of international economics.

I. Classical Theory of International Trade

In 1817, David Ricardo, an English political economist, contributed theory of comparative advantage in his book '*Principles of Political Economy and Taxation*'. This theory of comparative advantage, also called comparative cost theory, is regarded as the classical theory of international trade.

According to the classical theory of international trade, every country will produce their commodities for the production of which it is most suited in terms of its natural endowments climate quality of soil, means of transport, capital, etc. It will produce these commodities in excess of its own requirement and will exchange the surplus with the imports of goods from other countries for the production of which it is not well suited or which it cannot produce at all. Thus all countries produce and export these commodities in which they have cost advantages and import those commodities in which they have cost disadvantages.

Types of Cost Difference in Production

- Economists speak about three types of cost difference in production, they are
- Absolute cost difference,
- Equal cost difference, and
- Comparative cost difference.

1. Absolute Cost Differences:-

Adam Smith in his book '*Wealth of Nation*' argued that international trade is advantageous for all the participating countries only if they enjoy absolute differences in the cost of production of the commodity which they specialize. As in the case of individuals where each specializes in the production of that commodity in which he has an absolutely superiority in terms of cost, so also each country specializes in production of goods based on absolute advantage.

The principle of absolute difference in cost can be explained with the help of table given below. Let us assume that we have 2 countries, I and II specializing in the production of X and Y.

One Day's Labour Produces

Country	Commodity X (in Units)	Commodity Y (in Units)	Internal Exchange Rate	
			X	Y
I	20	10	2 :	1
II	10	20	1 :	2

In country I, one day's labour produces 20x or 10y. The internal exchange rate is 2 : 1. In country II, one day's labour produce 10x or 20y which gives us the domestic exchange rate of 1 : 2. Country I has the absolute advantage in the production of X (as 20 > 10) and country II in Y (as 10 < 20). If these countries enter into trade with the international exchange of 1 : 1, both countries stand to benefit. Country I will have 1y for 1x as against $^{1}/_{2y}$ for 1x within the country. Similarly country II will have 1x for 1y as against $^{1}/_{2x}$ for 1y within the country.

Based on this example, according to Adam Smith, it can be pointed out that international trade to be beneficial, each country must enjoy absolute difference in cost of production.

2. Equal Difference in Cost :--

Adam Smith, in order to strengthen his argument in favour of absolute difference in cost pointed out that trade is not possible if countries operate under equal difference in cost instead of absolute difference.

One Day's Labour Produces

Country	Commodity X (in Units)	Commodity Y (in Units)	Internal Exchange Rate	
			X	Y
I	20	10	2 :	1
II	10	5	2 :	1

The above table gives us the internal exchange rate 2x : 1y in both countries. Since the exchange ratio between X and Y in both countries is the same; none of them will benefit by entering into international trade.

Based on this example, according to Adam Smith, for international trade to be beneficial countries must enjoy absolute difference in cost. Trade would not take place when the difference in cost is equal.

3. Comparative Difference in Cost :--

David Ricardo agreed that absolute difference in cost gives a clear reason for trade to take place. He, however, went further to argue that even that the country has absolute advantage in the production of both commodities it is beneficial for that country to specialise in the production of that commodity in which it has a greater comparative advantage. The other country can be left to specialise in the production of that commodity in which it has less comparative advantage. According to Ricardo the essence for international trade is not the absolute difference in cost but comparative difference in cost.

Ricardo's Theory of Comparative Advantage :

David Ricardo stated a theory that other things being equal a country tends to specialise in and exports those commodities in the production of which it has maximum comparative cost advantage or minimum comparative disadvantage. Similarly the country's imports will be of goods having relatively less comparative cost advantage or greater disadvantage.

a. Ricardo's Assumptions :-

Ricardo explains his theory with the help of following assumptions :-

- There are two countries and two commodities.
- There is a perfect competition both in commodity and factor market.
- Cost of production is expressed in terms of labour i.e. value of a commodity is measured in terms of labour hours/days required to produce it. Commodities are also exchanged on the basis of labour content of each good.
- Labour is the only factor of production other than natural resources.
- Labour is homogeneous i.e. identical in efficiency, in a particular country.
- Labour is perfectly mobile within a country but perfectly immobile between countries.
- There is free trade i.e. the movement of goods between countries is not hindered by any restrictions.
- Production is subject to constant returns to scale.
- There is no technological change.
- Trade between two countries takes place on barter system.
- Full employment exists in both countries.
- There is no transport cost.

b. Ricardo's Example :-

On the basis of assumptions, Ricardo explained his comparative cost difference theory, by taking an example of England and Portugal as two countries & Wine and Cloth as two commodities.

As pointed out in the assumptions, the cost is measured in terms of labour hour. The principle of comparative advantage expressed in labour hours by the following table.

	1 Unit Of Wine	1 Unit of Cloth
England	120	100
Portugal	80	90

Portugal requires less hours of labour for both wine and cloth. One unit of wine in Portugal is produced with the help of 80 labour hours as above 120 labour hours required in England. In the case of cloth too, Portugal requires less labour hours than England. From this it could be argued that there is no need for trade as Portugal produces both commodities at a lower cost. Ricardo however tried to prove that Portugal stands to gain by specialising in the commodity in which it has a greater comparative advantage. Comparative cost advantage of Portugal can be expressed in terms of cost ratio.

• Cost ratios of producing Wine and Cloth

Portugal			England		
Wine		Cloth	Wine		Cloth
$\frac{80}{120}$	>	$\frac{90}{100}$	$\frac{120}{80}$	>	$\frac{100}{90}$
0.66	<	0.9	1.5	>	1.11

Portugal has advantage of lower cost of production both in wine and cloth. However the difference in cost, that is the comparative advantage is greater in the production of wine (1.5 — 0.66 = 0.84) than in cloth (1.11 — 0.9 = 0.21).

Even in the terms of absolute number of days of labour Portugal has a large comparative advantage in wine, that is, 40 labourers less than England as compared to cloth where the difference is only 10, (40 > 10). Accordingly Portugal specialises in the production of wine where its comparative advantage is larger. England specialises in the production of cloth where its comparative disadvantage is lesser than in wine.

• Comparative Cost Benefits Both Participants

Let us explain Ricardian contention that comparative cost benefits both the participants, though one of them had clear cost advantage in both commodities. To prove it, let us work out the internal exchange ratio.

	Wine	Cloth	Domestic Exchange Rate		
			W	:	C
England	120	100	1	:	1.2
Portugal	80	90	1	:	0.89

Let us assume these 2 countries enter into trade at an international exchange rate (Terms of Trade) 1 : 1. At this rate, England specializes in cloth and exporting one unit of cloth gets one unit of wine. At home it is required to give 1.2 units of cloth for one unit of wine. England thus gains 0.2 of cloth i.e. wine is cheaper from Portugal by 0.2 unit of cloth.

Similarly Portugal gets one unit of cloth from England for its one unit of wine as against 0.89 of cloth at home thus gaining extra cloth of 0.11. Here both England and Portugal gain from the trade i.e. England gives 0.2 less of cloth to get one unit of wine and Portugal gets 0.11 more of cloth for one unit of wine.

In this example, Portugal specializes in wine where it has greater comparative advantage leaving cloth for England in which it has less comparative disadvantage.

Thus comparative cost theory states that each country produces & exports those goods in which they enjoy cost advantage & imports those goods suffering cost disadvantage.

II. Heckscher-Ohlin Model :

In the early 1900s an international trade theory called factor proportions theory emerged by two Swedish economists, Eli Heckscher and Bertil Ohlin. This theory is also called the Heckscher-Ohlin theory. The Heckscher-Ohlin theory stresses that countries should produce and export goods that require resources (factors) that are abundant and import goods that require resources in short supply. This theory differs from the theories of comparative advantage and absolute advantage since those theories focus on the productivity of the production process for a particular good. On the contrary, the Heckscher-Ohlin theory states that a country should specialize production and export using the factors that are most abundant, and thus the cheapest. Not to produce, as earlier theories stated, the goods it produces most efficiently.

The Heckscher-Ohlin model was produced as an alternative to the Ricardian model of basic comparative advantage. Despite its greater complexity it did not prove much more accurate in its predictions. However from a theoretical point of view it did provide an elegant solution by incorporating the neoclassical price mechanism into international trade theory.

The theory argues that the pattern of international trade is determined by differences in factor endowments. It predicts that countries will export those goods that make intensive use of locally abundant factors and will import goods that make intensive use of factors that are locally scarce. Empirical problems with the H-O model, known as the Leontief paradox, were exposed in empirical tests by Wassily Leontief who found that the United States tended to export labor intensive goods despite having capital abundance.

The Heckscher-Ohlin theory explains why countries trade goods and services with each other. One condition for trade between two countries is that the countries differ with respect to the availability of the factors of production. They differ if one country, for example, has many machines (capital) but few workers, while another country has a lot of workers but few machines. According to the Heckscher-Ohlin theory, a country specializes in the production of goods that it is particularly suited to produce. Countries in which capital is abundant and workers are few, therefore, specialize in production of goods that, in particular, require capital. Specialization in production and trade between countries generates, according to this theory, a higher standard-of-living for the countries involved.

The production of goods and services requires capital and workers. Some goods require more capital - technical equipment and machinery - and are called *capital intensive.* Examples of these goods are cars, computers, and cell phones.

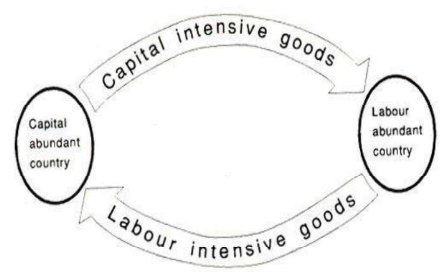
Other goods require less equipment to produce and rely mostly on the efforts of the workers. These goods are called *labor intensive*. Examples of these goods are shoes and textile products such as jeans.

Gains from Trade

By specializing in production, and by trading with other countries, it is possible for countries to increase their incomes. Even though countries as a whole benefit from specialization and international trade, all groups in society, workers and capitalists, do not gain according to the Heckscher-Ohlin theory. If international trade leads a country to specialize in producing goods that require lots of workers and little capital, such a specialization increases wages (which benefits the workers) but decreases the income of the capital owners. But the country as a whole benefits because, the gain of the workers is bigger than the loss of the capital owners.

Assumptions:

Heckscher-Ohlin's theory explains the modern approach to international trade on the basis of following assumptions :-



1. There are two countries involved.
2. Each country has two factors (labour and capital).
3. Each country produce two commodities or goods (labour intensive and capital intensive).
4. There is perfect competition in both commodity and factor markets.
5. All production functions are homogeneous of the first degree i.e. production function is subject to constant returns to scale.
6. Factors are freely mobile within a country but immobile between countries.
7. Two countries differ in factor supply.
8. Each commodity differs in factor intensity.
9. The production function remains the same in different countries for the same commodity. For e.g. If commodity **A** requires more capital in one country then same is the case in other country.
10. There is full employment of resources in both countries and demand is identical in both countries.
11. Trade is free i.e. there are no trade restrictions in the form of tariffs or non-tariff barriers.
12. There are no transportation costs.

Given these assumptions, Ohlin's thesis contends that a country export goods which use relatively a greater proportion of its abundant and cheap factor. While same countries import goods whose production requires the intensive use of the nation's relatively scarce and expensive factor.

The Concept of Factor Abundance

In the two countries, two commodities & two factor model, implies that the capital rich country will export capital intensive commodity and the labour rich country will export labour intensive commodity. But the concept of country being rich in one factor or other is not very clear. Economists quite often define factor abundance in terms of factor prices. Ohlin himself has followed this approach. Alternatively factor abundance can be defined in physical terms. In this case, physical amounts of capital & Labour are to be compared.

• Price Criterion for defining Factor Abundance

A country where capital is relatively cheaper and labour is relatively costly is said to be capital rich country. Whereas a country where labour is relatively cheaper and capital is relatively costly is said to be labour rich country.

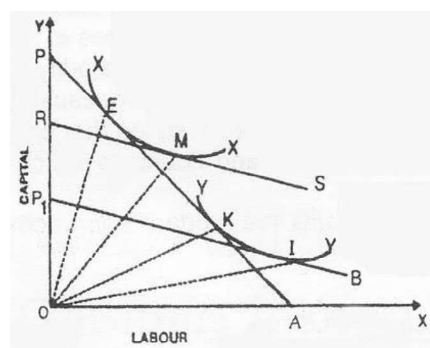
Price of the factor can be symbolically measured as follows:-

$$\left(\frac{PK}{PL}\right)_E < \left(\frac{PK}{PL}\right)_I$$

In above relation - P refers to price of the factor, K refers to Capital, L refers to Labour, E stands for England, and I stands for India.

The above analysis highlights a fact that in England capital is cheap, and hence it is a capital abundant country. Whereas in India, Labour is cheaper, and thus it is a labour rich country. Now lets understand how such a pattern of trade will necessarily emerge.

• Diagram Explaining Heckscher Ohlin's H-O Theory



Let us take an example of same two countries viz; England and India where England is a capital rich country while India is a labour abundant nation.

In the above diagram XX is the isoquant (equal product curve) for the commodity X produced in England. YY is the isoquant representing commodity Y produced in India. It is very clear that XX is relatively capital intensive while YY is relatively labour incentive. The factor capital is represented on Y- axis while the factor labour is represented on the horizontal X-axis.

PA is the price line or budget line of the country England. The price line PA is tangent to XX at E. The price line PA is also tangent to YY isoquant at K. The point K will help us to find out how much of capital and labour is required to produce one unit of Y in England.

P_1B is the price line of the country India, The price line P_1B is tangent to YY at I. The price line RS which is drawn parallel to P_1B is tangent to XX at M. This will help us to find out how much of capital and labour is required to produce one unit of commodity X in India.

Under the given situations, the country England will choose the combination E. Which means more specialisation on capital goods. It will not choose the combination K because it is more labour intensive and less capital intensive.

Thus according to Ohlin, England will specialize on production of goods X by using the cheap factor capital extensively while India specializes on commodity Y by using the cheap factor labour available in the country.

The Ohlin's theory concludes that :-

- The basis of internal trade is the difference in commodity prices in the two countries.
- Differences in the commodity prices are due to cost differences which are the results of differences in factor endowments in two countries.
- A capital rich country specializes in capital intensive goods & exports them. While a Labour abundant country specializes in labour intensive goods & exports them.

Reality and Applicability of the Heckscher-Ohlin Model

The Heckscher-Ohlin theory is preferred to the Ricardo theory by many economists, because it makes fewer simplifying assumptions. In 1953, Wassily Leontief published a study, where he tested the validity of the Heckscher-Ohlin theory. The study showed that the U.S was more abundant in capital compared to other countries; therefore the U.S would export capital-intensive goods and import labour-intensive goods. Leontief found out that the U.S's export was less capital intensive than import.

After the appearance of Leontief's paradox, many researchers tried to save the Heckscher-Ohlin theory, either by new methods of measurement, or either by new interpretations. Leamer emphasized that Leontief did not interpret HO theory properly and claimed that with a right interpretation paradox did not occur. Brecher and Choudri found that, if Leamer was right, the American workers consumption per head should be lower than the workers world average consumption.

Many other trials followed but most of them failed. Many famous textbook writers, including Krugman and Obstfeld and Bowen, Hollander and Viane, are negative about the validity of H-O model. After examining the long history of empirical research, Bowen, Hollander and Viane concluded: "Recent tests of the factor abundance theory [H-O theory and its developed form into many-commodity and many-factor case] that directly examine the H-O-V equations also indicate the rejection of the theory."

Heckscher -Ohlin theory is not well adapted to the analyze South-North trade problems. The assumptions of HO are less realistic with respect to N-S than N-N (or S- S) trade. Income differences between North and South is the one that third world cares most. The factor price equalization [a consequence of HO theory] has not shown much sign of realization. HO model assumes identical production functions between countries. This is highly unrealistic. Technological gap between developed and developing countries is the main concern of the poor countries.

Limitations of Heckscher Ohlin's H-O Theory:

Heckscher Ohlin's Theory has been **criticised** on basis of following grounds :-

- **Unrealistic Assumptions**: Besides the usual assumptions of two countries, two commodities, no transport cost, etc. Ohlin's theory also assumes no qualitative difference in factors of production, identical production function, constant return to scale, etc. All these assumptions makes the theory unrealistic one.

- **Restrictive**: Ohlin's theory is not free from constrains. His theory includes only two commodities, two countries and two factors. Thus it is a restrictive one.

- **One-Sided Theory**: According to Ohlin's theory, supply plays a significant role than demand in determining factor prices. But if demand forces are more significant, a capital abundant country will export labour intensive good as the price of capital will be high due to high demand for capital.

- **Static in Nature**: Like Ricardian Theory the H-O Model is also static in nature. The theory is based on a given state of economy and with a given production function and does not accept any change.

- **Wijnholds's Criticism**: According to Wijnholds, it is not the factor prices that determine the costs and commodity prices but it is commodity prices that determine the factor prices.

- **Consumers' Demand ignored**: Ohlin forgot an important fact that commodity prices are also influenced by the consumers' demand.

- **Haberler's Criticism**: According to Haberler, Ohlin's theory is based on partial equilibrium. It fails to give a complete, comprehensive and general equilibrium analysis.

- **Leontief Paradox**: American economist Dr. Wassily Leontief tested H-O theory under U.S.A conditions. He found out that U.S.A exports labour intensive goods and imports capital intensive goods, but U.S.A being a capital abundant country must export capital intensive goods and import labour intensive goods than to produce them at home. This situation is called Leontief Paradox which negates H-O Theory.

- **Other Factors Neglected**: Factor endowment is not the sole factor influencing commodity price and international trade. The H-O Theory neglects other factors like technology, technique of production, natural factors, different qualities of labour, etc., which can also influence the international trade.

Evaluation of the H-O Theory

The Heckscher- Ohlin theory has been often criticised for its wrong assumptions. Studies conducted by Leontief and some others tend to question even the validity of the theory. (For details *see* the section on "Empirical Testing of the H-O Model"). Despite its drawbacks, however, the Heckscher-Ohlin theory has certain definite merits.

1. The Heckscher-Ohlin theory rightly points out that the immediate basis of international trade is the difference in the final price of a commodity between countries, although the actual basis or ultimate cause of trade is comparative cost difference in production. Thus, the Heckscher-Ohlin theory provides a more comprehensive and satisfactory explanation for the existence of international trade.

2. The Heckscher-Ohlin theory is Superior to the comparative cost theory in another respect. The Ricardian theory points out that comparative cost difference is the basis of international trade, but it does not explain the reasons for the existence of comparative cost differences between nations. The Heckscher-Ohlin theory explains the reasons for the differences in the cost of production in terms of differences in factor endowments. This is another aspect that makes it superior to the Ricardian analysis.

3. Further, Heckscher and Ohlin make it very clear that "International trade is but a special case of inter-local or inter-regional trade" and hence there is no need for a special theory of international trade. Ohlin states that regions and nations trade with each other for the same reasons that individuals Specialise and trade. The comparative cost differences are the basis of all trade-inter-regional as well as international. Nations, according to Ohlin, are only regions distinguished from one another by such obvious marks as national frontiers, tariff barriers and differences in language, customs and monetary systems.

The *modern* theory of trade is also called the *General Equilibrium Theory* of international trade because it points out that the general demand and supply analysis applicable to inter-regional trade can generally be used without substantial changes in dealing with problems of international trade.

4. Another merit of the Heckscher-Ohlin theory is that it indicates the impact of trade on product and factor prices.

The Heckscher -Ohlin theory indicates that international trade will ultimately have the following results:

Equalization of Commodity Prices

International trade tends to equalize the prices of internationally traded goods in all the regions of the world because trade causes the movement of commodities from areas where they are abundant to areas where they are scarce. This would tend to increase commodity prices where there was abundance and decrease prices where there was scarcity due to the redistribution of commodity supply between these two regions as a result of trade. International trade tends to expand up to the point where prices in all regions become equal. But perfect equality of prices can hardly be achieved due to the existence of transport costs and due to the absence of free trade and perfect competition.

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2.2. WORLD TRADE ORGANISATION (WTO)

The World Trade Organization (WTO) came into being on January 1st 1995. It was the outcome of the lengthy (1986-1994) Uruguay round of GATT negotiations. The WTO was essentially an extension of GATT. It extended GATT in two major ways. First GATT became only one of the three major trade agreements that went into the WTO (the other two being the General Agreement on Trade in Services (GATS) and the agreements on Trade Related Aspects of Intellectual Property Rights (TRIPS)) . Second the WTO was put on a much sounder institutional footing than GATT. With GATT the support services that helped maintain the agreement had come into being in an ad hoc manner as the need arose. The WTO by contrast is a fully fledged institution (GATT also was, at least formally, only an agreement between contracting parties and had no independent existence of its own while the WTO is a corporate body recognized under international law).

Principles of the WTO

The basic principles of the WTO (according to the WTO):

- Trade Without Discrimination
- No Most Favoured Nation (MFN) Treatment - no special deals to trading partners, all members of WTO must be treated the same
- No National Special Treatment - locals and foreigners are treated equally
- Freer Trade
- Predictability through Binding - promising not to raise tariffs is called binding a tariff and binding leads to greater certainty for businesses
- Promoting Fair Competition
- Encouraging Development and Economic Reform

Scope, Functions, and Structure of the WTO

The WTO is headed by a ministerial conference of all members that meets at least once every two years. By contrast, under the GATT a decade could pass between ministerial meetings. The more frequent participation by trade ministers under the WTO was intended to strengthen the political guidance of the WTO and enhance the prominence and credibility of its rules in domestic political arenas. Article II of the Marrakech Agreement that established the WTO charges the organization with providing a common institutional framework for the conduct of trade relations among its members in matters to which agreements and associated legal obligations apply. Four annexes to the WTO define the substantive rights and obligations of members. Annex 1 has three parts: Annex 1A, Multilateral Agreements on Trade in Goods, which contains the GATT 1994 (the GATT 1947 as amended by a large number of understandings and supplementary agreements negotiated in the Uruguay Round); Annex 1B, which contains the GATS; and Annex 1C, the TRIPS agreement. Annex 2 contains the Understanding on Rules and Procedures Governing the Settlement of Disputes (DSU)—the WTO's common dispute settlement mechanism. Annex 3 contains the Trade Policy Review Mechanism (TPRM), an instrument for surveillance of members' trade policies. Finally, Annex 4, Plurilateral Trade Agreements, consists of Tokyo Round codes that were not multilateralized in the Uruguay Round and that therefore bind only their signatories. Together, Annexes 1 through 3 embody the multilateral trade agreements. Article II of the WTO specifies that all the agreements contained in these three annexes are an integral part of the WTO agreement and are binding on all members.

All of these instruments are discussed further in this chapter or in other chapters of this volume, The WTO is charged with facilitating the implementation and operation of the multilateral trade agreements, providing a forum for negotiations, administering the dispute settlement mechanism, exercising multilateral surveillance of trade policies, and cooperating with the World Bank and the IMF to achieve greater coherence in global economic policymaking (Art. III WTO). Between meetings of the ministerial conference, which is responsible for carrying out the functions of the WTO, the organization is managed by the General Council, at the level of diplomats. The General Council meets about 12 times a year. On average, about 70 percent of all

WTO members take part in its meetings, at which members are usually represented by delegations based in Geneva. The General Council turns itself, as needed, into a body that adjudicates trade disputes (the Dispute Settlement Body, or DSB) or that reviews members' trade policies (the Trade Policy Review Body, or TPRB).

Three subsidiary councils, on goods, on services, and on intellectual property rights, operate under the general guidance of the General Council. Separate committees deal with the interests of developing countries (Committee on Trade and Development); surveillance of trade restriction actions taken for balance of payment purposes; surveillance of regional trade agreements; trade-environment linkages; and WTO finances and administration. Additional committees or working parties deal with matters covered by the GATT, the GATS, or the TRIPS agreement. There are committees, functioning under the auspices of the Council on Trade in Goods, on subsidies, antidumping and countervailing measures, technical barriers to trade (product standards), import licensing, customs valuation, market access, agriculture, sanitary and phytosanitary measures, trade-related investment measures, rules of origin, and safeguards. In addition, working groups have been established to deal with notifications, with state-trading enterprises, with the relationships between trade and investment and between trade and competition policy, and with the issue of transparency in government procurement. Specific committees address matters relating to the GATS or the TRIPS agreement. All WTO members may participate in all councils, committees, and other bodies, with the exceptions of the Appellate Body, dispute settlement panels, the Textiles Monitoring Body, and committees dealing with plurilateral agreements.

About 40 councils, committees, subcommittees, bodies, and standing groups or working parties functioned under WTO auspices in 2000, more than twice the number under the GATT. Such bodies are open to all WTO members, but generally only the more important trading nations (less than half of the membership) regularly send representatives to most meetings. The degree of participation reflects a mix of national interests and resource constraints. The least-developed countries, in particular, tend not to be represented at these meetings; often, they do not have delegations based in Geneva. All of these fora, plus working parties on accession (averaging close to 30 in the late 1990s), dispute settlement panels, meetings of regional groups, meetings of heads of delegations, and numerous ad hoc and informal groups add up to 1,200 events a year at or near WTO headquarters in Geneva. Most WTO business is conducted in English, but many official WTO meetings require French and Spanish interpretation.

The main actors in the day-to -day activities are officials affiliated with the delegations of members. The WTO—like the 1947 GATT—is therefore something of a network organization (Blackhurst 1998) . The WTO secretariat is the hub of a very large and dispersed network comprising official representatives of members based in Geneva, civil servants based in capitals, and national business and nongovernmental groups that seek to have their governments push for their interests at the multilateral level. The operation of the WTO depends on the collective input of thousands of civil servants and government officials who deal with trade issues in each member country.

Initiatives to launch multilateral trade negotiations and to settle disputes—the two highest-profile activities of the WTO—are the sole responsibility of WTO members themselves, not the secretariat. The member-driven nature of the organization puts a considerable strain on the national delegations of members. Many countries have no more than one or two persons dealing with WTO matters; a large minority has no delegations in Geneva at all.

Decision making

Most decision making in the WTO follows GATT practices and is based on consultation and consensus. The consensus practice is of value to smaller countries, as it enhances their negotiating leverage in the informal consultations and bargaining that precede decision making, especially if they are able to form coalitions. Although recourse to voting may be had if a consensus cannot be reached, in practice voting occurs only very rarely. If a vote is needed, it is based on the principle of "one member, one vote." Unanimity is required for amendments relating to general principles such as MFN or national treatment. Interpretation of the provisions of the WTO agreements and decisions on waivers of a member's obligations require approval by a three quarters majority vote. A two-thirds majority vote is sufficient for amendments relating to issues other than the general principles mentioned above.

Where not otherwise specified, and where consensus cannot be reached, a simple majority vote is, in principle, sufficient. In practice, voting does not occur. Indeed, in 1995 WTO members decided not to apply provisions allowing for a vote in the case of accessions and requests for waivers but to continue to proceed on the basis of consensus (WT/L/93). Legislative amendments are also likely to be quite rare, as, in practice, changes to the various agreements occur as part of broader multilateral rounds.

Management of the Secretariat and Daily Operations

Unlike the World Bank and the IMF, the WTO does not have an executive body or a board comprising a subset of members some of whom represent a number of countries. Such executive boards facilitate Decision making by concentrating discussions within a smaller but representative group of members. The closest the GATT ever came to such a forum was the Consultative Group of Eighteen (CG18), established in 1975. It ceased meeting in 1985 and never substituted for the GATT Council of Representatives. As of January 1, 2002, the WTO had a membership of 144. Achieving consensus among such a large number of members is not a simple matter, and mechanisms have therefore been developed over the years to reduce the number of members that are active participants in WTO deliberations. The first and most important device is to involve only "principals," at least initially. To some extent this is a natural process; a country that has no agricultural sector is unlikely to be interested in discussions centering on the reduction of agricultural trade barriers. In general the "Quad" economies— Canada, the European Union, Japan, and the United States—are part of any group that forms to discuss any topic. They are supplemented by countries that have a principal supplying interest in a product and by the major (potential) importers whose policies are the subject of interest. Finally, a number of countries that have established a reputation as spokespersons tend to be involved in most major meetings. Historically, such countries have included Egypt, India, and Yugoslavia. During the Tokyo and Uruguay Rounds, contentious issues as to which deals had to be struck were often thrashed out in the "green room," a conference room adjacent to the Director- General's offices. Green-room meetings were part of a consultative process through which the major countries and a representative set of developing countries—a total of 20 or so delegations—tried to hammer out the outlines of acceptable proposals or negotiating agendas. Such meetings generally involved the active participation and input of the Director-General.

The convention now is to call such meetings green-room gatherings, no matter where they are held. The green-room process became a contentious issue during the Seattle ministerial meeting; many developing countries that were excluded from critical green-room meetings, where attempts were being made to negotiate compromise texts of a draft agenda for a new multilateral trade negotiation, felt that they were not being kept informed of developments and were not being granted the opportunity to defend their views. Proposals have been made periodically to formalize the green- room process by creating an executive committee to manage the WTO agenda, based on shares in world trade . To date, no progress in this direction has proved possible in the WTO.

FUNCTIONS AND BASIC PRINCIPLES

The basic functions of the WTO are:

a. Administering WTO trade agreements

The WTO shall facilitate the implementation, administration and operation, and further the objectives, of this Agreement and of the Multilateral Trade Agreements, and shall also provide the framework for the implementation, administration and operation of the Plurilateral Trade Agreements.

b. Forum for trade negotiations

The WTO shall provide the forum for negotiations among its Members concerning their multilateral trade relations in matters dealt with under the agreements in the Annexes to this Agreement. The WTO may also provide a forum for further negotiations among its Members concerning their multilateral trade relations, and a framework for the implementation of the results of such negotiations, as may be decided by the Ministerial Conference.

c. Handling trade disputes

The WTO shall administer the Understanding on Rules and Procedures Governing the Settlement of Disputes (hereinafter referred to as the "Dispute Settlement Understanding" or "DSU") in Annex 2 to this Agreement.

d. Monitoring national trade policies

The WTO shall administer the Trade Policy Review Mechanism (hereinafter referred to as the "TPRM") provided for in Annex 3 to this Agreement.

e. Technical assistance and training for developing countries - Cooperation with other international organizations

With a view to achieving greater coherence in global economic policy-making, the WTO shall cooperate, as appropriate, with the International Monetary Fund and with the International Bank for Reconstruction and Development and its affiliated agencies.

The WTO, established in 1995, administers the trade agreements negotiated by its members, in particular the General Agreement on Tariffs and Trade (GATT), the General Agreement on Trade in Services (GATS), and the Trade-Related Aspects of Intellectual Property Rights (TRIPS) agreement. The WTO builds on the organizational structure that had developed under GATT auspices as of the early 1990s. The origins of the GATT were in the abortive negotiations to create an International Trade Organization (ITO) following World War II. Negotiations on the charter of such an organization were concluded successfully in Havana in 1948, but the talks did not lead to the establishment of the ITO because the U.S. Congress was expected to refuse to ratify the agreement. Meanwhile, the GATT was negotiated in 1947 by 23 countries—12 industrial and 11 developing— before the ITO negotiations were concluded.

As the ITO never came into being, the GATT was the only concrete result of the negotiations. Since 1947, the GATT has been the major focal point for industrial country governments seeking to lower trade barriers. Although the GATT was initially largely limited to a tariff agreement, over time, as average tariff levels fell, it increasingly came to concentrate on nontariff trade policies and domestic policies having an impact on trade. Its success was reflected in a steady expansion in the number of contracting parties. By the end of the Uruguay Round (1994), 128 countries had joined the GATT. Since the entry into force of the WTO, membership has grown to 144, as of the end of 2001.

The WTO differs in a number of important respects from the GATT. The GATT was a rather flexible institution; bargaining and deal-making lay at its core, with significant opportunities for countries to “opt out” of specific disciplines. In contrast, WTO rules apply to all members, who are subject to binding dispute settlement procedures. This is attractive to groups seeking to introduce multilateral disciplines on a variety of subjects, ranging from the environment and labor standards to competition and investment policies to animal rights. But it is a source of concern to groups that perceive the (proposed) multilateral rules to be inappropriate or worry that the adoption of specific rules may affect detrimentally the ability of governments to regulate domestic activities and deal with market failures.

The main function of the WTO is as a forum for international cooperation on trade-related policies— the creation of codes of conduct for member governments. These codes emerge from the exchange of trade policy commitments in periodic negotiations. The WTO can be seen as a market in the sense that countries come together to exchange market access commitments on a reciprocal basis. It is, in fact, a barter market. In contrast to the markets one finds in city squares, countries do not have access to a medium of exchange: they do not have money with which to buy, and against which to sell, trade policies. Instead they have to exchange apples for oranges: for example, tariff reductions on iron for foreign market access commitments regarding cloth. This makes the trade policy market less efficient than one in which money can be used, and it is one of the reasons that WTO negotiations can be a tortuous process. One result of the market exchange is the development of codes of conduct.

The WTO contains a set of specific legal obligations regulating trade policies of member states, and these are embodied in the GATT, the GATS, and the TRIPS agreement.

Basic Principles

The WTO establishes a framework for trade policies; it does not define or specify outcomes. That is, it is concerned with setting the rules of the trade policy game, not with the results of the game. Five principles are of particular importance in understanding both the pre-1994 GATT and the WTO:nondiscrimination, reciprocity, enforceable commitments, transparency, and safety valves.

Non-discrimination

Non- discrimination has two major components: the most-favored-nation (MFN) rule, and the national treatment principle. Both are embedded in the main WTO rules on goods, services, and intellectual property, but their precise scope and nature differ across these three areas. This is especially true of the national treatment principle, which is a specific, not a general commitment when it comes to services. The MFN rule requires that a product made in one member country be treated no less favorably than a “like” (very similar) good that originates in any other country. Thus, if the best treatment granted a trading partner supplying a specific product is a 5 percent tariff, this rate must be applied immediately and unconditionally to imports of this good originating in all WTO members. In view of the small number of contracting parties to the GATT (only 23 countries), the benchmark for MFN is the best treatment offered to any country, including countries that are not members of the GATT. National treatment requires that foreign goods, once they have satisfied whatever border measures are applied, be treated no less favorably, in terms of internal (indirect) taxation than like or directly competitive domestically produced goods (Art. III, GATT). That is, goods of foreign origin circulating in the country must be subject to taxes, charges, and regulations that are “no less favorable” than those that apply to similar goods of domestic origin.

The MFN rule applies unconditionally. Although exceptions are made for the formation of free trade areas or customs unions and for preferential treatment of developing countries, MFN is a basic pillar of the WTO. One reason for this is economic: if policy does not discriminate between foreign suppliers, importers and consumers will have an incentive to use the lowest-cost foreign supplier. MFN also provides smaller countries with a guarantee that larger countries will not exploit their market power by raising tariffs against them in periods when times are bad and domestic industries are clamoring for protection or, alternatively, give specific countries preferential treatment for foreign policy reasons. MFN helps enforce multilateral rules by raising the costs to a country of defecting from the trade regime to which it committed itself in an earlier multilateral trade negotiation. If the country desires to raise trade barriers, it must apply the changed regime to all WTO members. This increases the political cost of backsliding on trade policy because importers will object. Finally, MFN reduces negotiating costs: once a negotiation has been concluded with a country, the results extend to all. Other countries do not need to negotiate to obtain similar treatment; instead, negotiations can be limited to principal suppliers.

National treatment ensures that liberalization commitments are not offset through the imposition of domestic taxes and similar measures. The requirement that foreign products be treated no less favorably than competing domestically produced products gives foreign suppliers greater certainty regarding the regulatory environment in which they must operate. The national treatment principle has often been invoked in dispute settlement cases brought to the GATT. It is a very wide-ranging rule: the obligation applies whether or not a specific tariff commitment was made, and it covers taxes and other policies, which must be applied in a nondiscriminatory fashion to like domestic and foreign products. It is also irrelevant whether a policy hurts an exporter. What matters is the existence of discrimination, not its effects.

Reciprocity

Reciprocity is a fundamental element of the negotiating process. It reflects both a desire to limit the scope for free-riding that may arise because of the MFN rule and a desire to obtain “payment” for trade liberalization in the form of better access to foreign markets. A rationale for reciprocity can be found in the political-economy literature. The costs of liberalization generally are concentrated in specific industries, which often will be well organized and opposed to reductions in protection. Benefits, although in the aggregate usually greater than costs, accrue to a much larger set of agents, who thus do not have a great individual incentive to organize themselves politically. In such a setting, being able to point to reciprocal, sector-specific export gains may help to sell the liberalization politically. Obtaining a reduction in foreign import barriers as a quid pro quo for a reduction in domestic trade restrictions gives specific export- oriented domestic interests that will gain from liberalization an incentive to support it in domestic political markets. A related point is that for a nation to negotiate, it is necessary that the gain from doing so be greater than the gain available from unilateral liberalization. Reciprocal concessions ensure that such gains will materialize.

Binding and Enforceable Commitments

Liberalization commitments and agreements to abide by certain rules of the game have little value if they cannot be enforced. The nondiscrimination principle, embodied in Articles I (on MFN) and III (on national treatment) of the GATT, is important in ensuring that market access commitments are implemented and maintained. Other GATT articles play a supporting role, including Article II (on schedules of concessions). The tariff commitments made by WTO members in a multilateral trade negotiation and on accession are enumerated in schedules (lists) of concessions. These schedules establish “ceiling bindings”: the member concerned cannot raise tariffs above bound levels without negotiating compensation with the principal suppliers of the products concerned. The MFN rule then ensures that such compensation—usually, reductions in other tariffs—extends to all WTO members, raising the cost of reneging. Once tariff commitments are bound, it is important that there be no resort to other, non -tariff, measures that have the effect of nullifying or impairing the value of the tariff concession. A number of GATT articles attempt to ensure that this does not occur. They include Article VII (customs valuation), Article XI, which prohibits quantitative restrictions on imports and exports, and the Agreement on Subsidies and Countervailing Measures, which outlaws export subsidies for manufactures and allows for the countervailing of production subsidies on imports that materially injure domestic competitors.

If a country perceives that actions taken by another government have the effect of nullifying or impairing negotiated market access commitments or the disciplines of the WTO, it may bring this situation to the attention of the government involved and ask that the policy be changed. If satisfaction is not obtained, the complaining country may invoke WTO dispute settlement procedures, which involve the establishment of panels of impartial experts charged with determining whether a contested measure violates the WTO. Because the WTO is an intergovernmental agreement, private parties do not have legal standing before the WTO’s dispute settlement body; only governments have the right to bring cases. The existence of dispute settlement procedures precludes the use of unilateral retaliation. For small countries, in particular, recourse to a multilateral body is vital, as unilateral actions would be ineffective and thus would not be credible. More generally, small countries have a great stake in a rule-based international system, which reduces the likelihood of being confronted with bilateral pressure from large trading powers to change policies that are not to their liking.

Transparency

Enforcement of commitments requires access to information on the trade regimes that are maintained by members. The agreements administered by the WTO therefore incorporate mechanisms designed to facilitate communication between WTO members on issues. Numerous specialized committees, working parties, working groups, and councils meet regularly in Geneva. These interactions allow for the exchange of information and views and permit potential conflicts to be defused efficiently.

Transparency is a basic pillar of the WTO, and it is a legal obligation, embedded in Article X of the GATT and Article III of the GATS.WTO members are required to publish their trade regulations, to establish and maintain institutions allowing for the review of administrative decisions affecting trade, to respond to requests for information by other members, and to notify changes in trade policies to the WTO. These internal transparency requirements are supplemented by multilateral surveillance of trade policies by WTO members, facilitated by periodic country- specific reports (trade policy reviews) that are prepared by the secretariat and discussed by the WTO General Council. The external surveillance also fosters transparency, both for citizens of the countries concerned and for trading partners. It reduces the scope for countries to circumvent their obligations, thereby reducing uncertainty regarding the prevailing policy stance. Transparency has a number of important benefits. It reduces the pressure on the dispute settlement system, as measures can be discussed in the appropriate WTO body. Frequently, such discussions can address perceptions by a member that a specific policy violates the WTO; many potential disputes are defused in informal meetings in Geneva. Transparency is also vital for ensuring "ownership" of the WTO as an institution—if citizens do not know what the organization does, its legitimacy will be eroded. The trade policy reviews are a unique source of information that can be used by civil society to assess the implications of the overall trade policies that are pursued by their governments. From an economic perspective, transparency can also help reduce uncertainty related to trade policy. Such uncertainty is associated with lower investment and growth rates and with a shift in resources toward non-tradables (Francois 1997). Mechanisms to improve transparency can help lower perceptions of risk by reducing uncertainty. WTO membership itself, with the associated commitments on trade policies that are subject to binding dispute settlement, can also have this effect.

Safety Valves

A final principle embodied in the WTO is that, in specific circumstances, governments should be able to restrict trade. There are three types of provisions in this connection:

(a) articles allowing for the use of trade measures to attain non-economic objectives;
(b) articles aimed at ensuring "fair competition"; and
(c) provisions permitting intervention in trade for economic reasons.

- Category (a) includes provisions allowing for policies to protect public health or national security and to protect industries that are seriously injured by competition from imports. The underlying idea in the latter case is that governments should have the right to step in when competition becomes so vigorous as to injure domestic competitors. Although it is not explicitly mentioned in the relevant WTO agreement, the underlying rationale for intervention is that such competition causes political and social problems associated with the need for the industry to adjust to changed circumstances.

- Measures in category (b) include the right to impose countervailing duties on imports that have been subsidized and antidumping duties on imports that have been dumped (sold at a price below that charged in the home market).

- Finally, under category (c) there are provisions allowing actions to be taken in case of serious balance of payments difficulties or if a government desires to support an infant industry.

Most agreements in the WTO are arrived at by consensus (i.e. everybody agrees - not one member dissents). Majority votes are possible but none so far have occurred. It is also worth noting that all the WTO's agreements have been ratified by the members states' parliaments (where such exist) in contrast to the case for GATT.

Ministerial Conference

There shall be a Ministerial Conference composed of representatives of all the Members, which shall meet at least once every two years. The Ministerial Conference shall carry out the functions of the WTO and take actions necessary to this effect. The Ministerial Conference shall have the authority to take decisions on all matters under any of the Multilateral Trade Agreements, if so requested by a Member, in accordance with the specific requirements for decision-making in this Agreement and in the relevant Multilateral Trade Agreement.

General Council

There shall be a General Council composed of representatives of all the Members, which shall meet as appropriate. In the intervals between meetings of the Ministerial Conference, its functions shall be conducted by the General Council. The General Council shall also carry out the functions assigned to it by this Agreement. The General Council shall establish its rules of procedure and approve the rules of procedure for the Committees provided for in paragraph 7.

Multitude of Committees, Bodies and Councils

For example: Dispute Settlement Body (DSU), Councils for Trade in Goods, Trade in Services and for TRIPS etc.

The Uruguay Round and the establishment of the WTO changed the character of the trading system. The GATT was very much a market access–oriented institution: its function was to harness the dynamics of reciprocity for the global good. Negotiators could be left to follow mercantilist logic, and the end result would be beneficial to all contracting parties. This dynamic worked less well for developing countries, where the burden of liberalization rested much more heavily on the shoulders of governments. Even if they wanted to, their scope to use the GATT was often limited because exporters had fewer incentives and were less powerful than in industrial countries. The reciprocal, negotiation driven dynamic also worked much less well for issues that were “lumpy” and where the terms of the debate revolved around what rules to adopt, not around how much of a marginal change was appropriate. Once discussions center on rules, especially on disciplines for domestic policy and regulations, it is more difficult to define intra issue compromises that make economic sense. Cross-issue linkage becomes necessary. Disengagement was not an option during the Uruguay Round (because of the “single undertaking”), so the task was to come up with a balanced package that ensured gains for all players. One can argue whether the package that emerged from the round was a balanced one; views on this point differ widely.

Whatever the conclusion, it is clear that the approach taken toward ensuring and supporting implementation of WTO agreements by developing countries was not an effective one. Limiting recognition of this problem to the setting of uniform transition periods was clearly inadequate. The case for uniform application of agreements that involve reducing trade barriers tariffs and non-tariff barriers is very strong. But in other areas requiring minimum levels of institutional capacity, such as customs valuation, a good case can be made that implementation should be linked to national capacity and international assistance.

A lesson from post–Uruguay Round experience and thinking is that trade policy should be made more central to the development process and development strategies. This needs to be done at both the national and international levels. At the national level it is necessary in order to ensure that governments have a basis on which to resist efforts to negotiate agreements in an area. Governments must be able to identify what types of rules will promote development and what types would lead to an inappropriate use of scarce resources. At the international level such a change is necessary in order to enhance the communication between trade and development assistance bodies in member countries. One reason for the implementation assistance problems that were encountered in the late 1990s was that the best-endeavors commitments on assistance that were made by industrial country trade negotiators were not “owned” by counterpart agencies in their governments that controlled development assistance money. Progress on both fronts would do much to ensure that future negotiations do not give rise to problems of the type that were created in the Uruguay Round.

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