Why did the Golden Age of Capitalism come to an end?

Objectives:
Students would be able to:
- Analyze the casual relationships that ended the golden age of capitalism
- Evaluate the relative significance of the various crisis that afflicted the global economy

Challenge 3: Rise of protectionism from 1970s

Reasons for the rise of protectionism
Economic slowdown in developed countries was brought about by several reasons:
- The dollar glut early 1970s–end of Bretton Woods, fluctuating exchange rates
- The 1970s oil crises
- Challenges/competition from the Third World
- Weakening of US economy
- World Debt crisis 1982

Weakening US economy
In the 1970s, 80s there was a surge in protectionist sentiment. This had been due to several reasons:
- The decline of American hegemony that followed from the resurgence in economic strength of Western Europe and Japan was one of the reasons.
- Also, with the economic preeminence being challenged, US interest in advancing the open trade regime was diminishing. Furthermore, there were the worsened economic circumstances that the developed countries were contending with during the 70s and 80s.

Most significant was the deterioration of the levels of economic activity; for the first time since WWII, these countries simultaneously experienced a serious recession in 1974-75 and their recovery was marred by slow economic growth, higher levels of unemployment and rising inflation. After OPEC's second oil price increase in 1979, monetary authorities sharply restricted the money supply as a counter-inflationary measure. In 1981-82, the world economy slid into severe post-war recessions with the debt crisis.

These conditions bred protectionist demands by businesses facing contracting markets at home and by workers fearing the spread of unemployment.

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Impact of oil crises
In the 1970s, major price increases, particularly for energy, created a strong fear of inflation—increases in the overall level of prices. As a result, government leaders came to concentrate more on controlling inflation than on combating recession by limiting spending, resisting tax cuts, and reining in growth in the money supply.

Budget and trade deficits

i) Stagflation
Since the stagflation of the 1970's, the U.S. economy has been characterized by somewhat slower growth. In 1985, the U.S. began its growing trade deficit with China. The US was experiencing a recession and the overvaluation of the dollar not only increased demand for protectionism generated by recession but also impaired the performance of exports.
- Richard Nixon took the United States off the Bretton Woods system, and further government attempts to revive the economy failed. When the Bretton Woods monetary system collapsed in 1973, it was replaced by the unfamiliar arrangement of fluctuating exchange rates.
- For countries exporting and importing goods from competitive industries, they experienced severe price competition because of exchange rate changes. i.e. The US dollar rose strongly against other currencies in the first half of the 1980s, its value against the yen increased by at least 60% between 1981 and 85. This gave added force to domestic producers' demands for relief through some measure of protectionism.

While it was believed that this arrangement would ease external balance-of-payments adjustments, it was not foreseen that exchange rates would become the subject of wide swings over several years.

ii) Rise in protectionism due to trade deficits
Since 1971, the USA has continually run trade deficits which rose steadily to $15 billion in 1981. It skyrocketed to $152 billion in 1987 as a result of the Reagan White House policies. It declined to $62 billion in 1991 and rose to $260 billion in 1998.

In comparison, the EU's growth rate is comparable to that of the USA. Until its stock and real estate market bubble burst in 1990, Japan's economy grew twice as fast as the US and its GNP was poised to surpass that of USA.

However, **from 1990 to 2000, Japan's growth lagged behind the US as Clinton's sound policies revitalized the nation's economy into its best performance since the 1960s.**

THIS SHOWS CHANGE & CONTINUTY OVER TIME AS THE US ECONOMY DID UNDERGO A REVIVAL IN THE 90S.

The US and EU continued to suffer vast trade deficits with Japan and have become increasingly protectionist, restricting about 45% and 60% of manufactured imports. Meanwhile, as a result of foreign pressure, Japan began relaxing their import restrictions. As fair trade rather than free trade gained popularity in the 1990s, the battle between the three economic powers became increasingly bitter and frequent.

iii) US Foreign Debt

USA's foreign debt is greater than that of the entire Third World, casting a negative effect on developing countries. As there is only a finite amount of global finance, the more the USA borrows, the less there is available for the Third World. This is because commercial bankers would rather lend to a creditworthy country than to a poor country with existing debt that is often rescheduled. US demand for international finances also raises interest rates which meant more Third World income is transferred to global bankers.

iv) Increased Competition Among Developed Countries

The ideological shift away from the post-war free trade consensus as countries struggled with the loss of dynamism in economic growth and with structural weaknesses. The rising protection lay in the reluctance of governments to expose industries to the market forces that would bring about adaptation to changing conditions. This was so to Western Europe where market rigidities traced to social legislation associated with the welfare state, especially rigidities in the labour market, were seen as generating resistance to adaptation.

Japan's Economic Miracle

Japan's competitive strength was initially in textiles and clothing, which moved on to the steel, shipbuilding and cars industry. Japan also competed with the developed countries in consumer electronics and semiconductors, this in turned challenged such countries with their ability to adapt. This triggered off reactions from the governments of these developed countries placing focus on the industries most affected by these changes/competitions.

Of the three major economic powers, Japan restricts foreign investments more than anyone else. Until recently, Tokyo sharply limited the amount and type of foreign investments within Japan. The government screened all foreign investments and allowed entry only if the MNC's products did not compete with those of Japanese firms targeted by the government for development. Even then, it they were limited to 49% share of investment, with Japanese investors holding the other 51%. Profits from most foreign investments could not be repatriated. In further screening the process, 100% foreign ownership was not allowed until passage of the 1980 Foreign Exchange and Foreign Trade Control Law. The law allowed the government the right to impede any foreign investment that violates national security.

Despite these legal changes, Tokyo has continued to screen foreign investments, inhibits those which are competitive with Japanese industry and has specific industry laws that empower it to impede foreign investments. Foreign MNCs face numerous unofficial obstacles to investing in Japan, restrictions on advertising, buying or renting land, business cartels that will not sell or buy from foreigners. MNCs can affect the trade balance, for example, the automobile Voluntary Export Restraints (VER) that Washington negotiated with Tokyo in 1981 was partially.an attempt to encourage Japan's manufacturers to invest directly in US in hope that it would reduce Japan's growing trade surplus. Japan's auto makers did open factories in US during the 1980s, but those investments actually exacerbated the trade deficit because the components were shipped from Japan.

- **Japanese Trade Surplus**

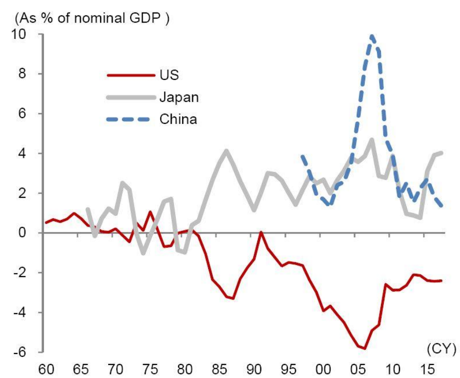
Compared to competitors, Japan was too successful. The Japanese economy weathered the difficulties engendered by the oil-price hikes of 1973 and 1979 better than its rivals and the result was that its trade surpluses with the US and EC began in the early 1980s to spiral out of control. This process was assisted by the fact that the first Reagan administration allowed the dollar to increase in value, thus making Japanese goods more competitive than ever in the American market.

In 1985, the US decided that the dollar should be devalued and a mechanism to ensure this was arranged by major economic powers in the **Plaza Accord**. However, at this stage, such was the productivity of Japanese production that even this move made little difference to its inroads into the American economy. Companies such as Toyota and Nissan ran subsidiary producers in the USA.

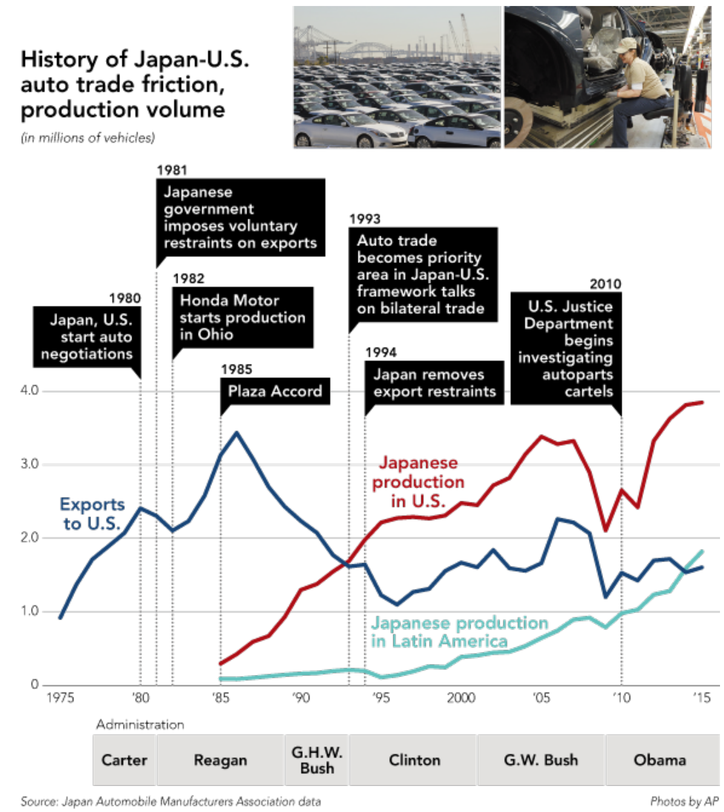
By the late 1980s, there was increasing pressure from Congress on the American executive to take tougher action against Japanese exports and foreign direct investment. Many American MNCs felt frustrated in having failed to gain a share in the lucrative Japanese market as it was a high income market and second to USA. Resentment was evident also with American MNCs having developed technology first only to see Japan take the lead. This has been compounded by a sheltered Japanese industrial policy of dominating the market at home and pursuing a pricing system abroad. Coupled by the US deficit in the 1980s while Japan reached a trade surplus, convinced the US the Japanese were not pursuing an open trade policy.

In 1992, Japan enjoyed a trade surplus of $132 billion of which $52 billion was with the US and $31 billion with the European Community. That same year while the total direct investments of Japanese corporations had reached $93 billion in the US and $55 billion in the European Community, total American and European direct investments in Japan were only $9.5 billion and $3.2 billion. Washington, Brussels and various European capitals have continually condemned Japan's immense and intractable trade and investment surpluses but to no avail.

Current account balances of the US, Japan, and China



Source: Nomura, based on US Department of Commerce, MOF, Cabinet Office, and IMF data



- **Japanese Neo-Mercantilism**

Japan has posed a serious geo-economic issue since its economy revived in the late 1940s. For four years between 1951 and 1955, the Europeans opposed Washington's attempts to sponsor Japan's membership in GATT. The Europeans argued that Tokyo would continue its neo-mercantilism despite its promises to abandon them to join GATT.

In 1955, Washington finally succeeded in gaining Tokyo GATT membership but most of the other members used GATT article 35, the 'safeguard clause', which allowed them to continue discriminating against Japanese imports. The US and Japan negotiated away these barriers through the 1960s.

In retaliation against Japanese neo-mercantilism, Europeans continued to keep out specific Japanese goods, although the type and amount varied from one country to the next. For example, Italy restricted Japanese automobiles to a 1% share, France 3% and Britain 11%, while the other Community members had fewer or no restrictions. Brussels retaliated promptly against most Japanese products, which quickly captured large market shares through dumping. By 1992, Voluntary Restraint Agreements (VRA)restricted 40% of Japanese exports to the EC.

***Neo-mercantilism:** a government's rapid development of the economy to achieve trade surplus with its competitors by systematically restricting imports, promoting exports, targeting strategic industries and technologies with subsidies, cartels and other, advantages.

- **Japan – US clashes over protected industries**

Washington clashed frequently with Tokyo over waves of Japanese dumping of various products in the US that hurt or bankrupted many American firms. The first negotiations began in 1955 over Japanese "dollar blouses", which were gaining market share from American producers. Conflicts and negotiations continued over various types of Japanese textiles throughout the 1960s, culminating with a 1969 agreement limiting Japanese imports to certain levels. In the late 1960s and into the 1970s, Japanese television and steel producers captured increased market share, and the remaining beleaguered American producers pressured the White House to intervene. The government's response to the television industry was too late and today no American television producers remain of those that existed during the mid-60s.

The White House was more prompt in responding to Japanese and European steel dumping. In 1968, Washington negotiated **VRAs (Voluntary Restraint Agreements)** with Japanese and European steel producers to limit their share of America's market. In 1978, the Carter administration responded to a new surge of Japanese steel dumping by imposing the "trigger price mechanism" in which any steel entering the US below a certain average Japanese production cost would automatically trigger a dumping investigation.

During the 1980s, the Reagan administration conducted two sets of negotiations. One tried to stem the influx of Japanese imports that threatened to destroy America's automobile, semiconductor, motorcycle and other industries.

Another attempted to reduce Japanese trade barriers and gain greater market share for such American products and services such as baseball bats, beef, oranges, semiconductors, portable telephones, satellites, lawyers, telecommunications equipment and banks to name a few.

Case Study: Conflict over automobiles

Washington negotiated with Tokyo a VER that restricted Japanese exports to $1.68 million from 1981 to 1984 and from $1.85 million from 1984 through the present. These restrictions may have well prevented the collapse of US' automobile industry but they cost the consumers over $5 billion in higher sticker prices as both US and Japanese producers raised prices in the restricted markets. Each American job saved cost over $160,000.

Between 1980 and 1985, the American automobile industry lost over $6 billion and 200,000 jobs while Japan's share of US' market rose 21%. By the late 1980s, Detroit was making a profit again, but Japan's producers made even higher profits and soon got around the restrictions by building automobile plants in USA. Between 1991 and 1992, US' Big Three lost over $6.5 billion and Japan's market share from exports and transplants rose to 30%.

Despite these losses, American auto makers have made enormous cost reduction and quality gains over the past decade, surpassing their Japanese rivals. In 1981, the average American car cost $1500 to $2500 more to produce than the average Japanese car. Although American labour costs still exceeded those of Japan, Ford and Chrysler have brought their parts, materials and other production costs far below those of their Japanese competitors.

The American producers are penalized by the fact that they use only 62% of capacity in 1991 whereas the Japanese used 95%, difference that cost the Americans $800 to $1500 more per car. Overall, US still has suffered nearly $45 billion automobile trade deficit with Japan despite the comparative advantage of Ford and Chrysler.

Case Study: Battle over computer chips

Another major battle of the 1980s was over computer chips. The Japanese are leading the microelectronics revolution mastering such interrelated fields as semiconductors, telecommunications, fiber optics, virtual reality and industrial ceramics.

Industries resemble food chains that include equipment makers, components, and finished products. Semiconductors are to the microelectronics industry what steel is to automobile and shipbuilding.

Japan's semiconductor makers captured enormous market share during the early 1980s because of the overvalued dollar and undervalued yen and massive dumping designed to drive their American and other foreign rivals into bankruptcy. This advantage was strengthened by the ability of Japanese firms to raise money at 4% interest rates in Japan's managed financial market system whereas American producers paid 12% in America's open capital market. By being to spend twice what the Americans were spending on research and development, the Japanese were able to offer a cheaper, better quality product.

In 1986, after years of pleading from US chipmakers, the Reagan White House agreed to negotiate a VER with Japan. An agreement was finally struck in which floor prices were set for Japanese chipmakers and US chipmakers were promised a 20% market share in Japan by 1991. The White House followed up this agreement by attempting a Japanese-style industrial policy in 1987, in which the White House allocated $100 million to help create Sematech, a semiconductor research consortium in a belated attempt to emulate and catch up to the Japanese.

Although the bilateral agreement and Sematech helped saved the American semiconductor industry, neither has fulfilled expectations. America's market share in Japan has risen from 8.5 % to 17.5% which represented $1 billion in additional sales; still short of Tokyo's promised 20% share. Likewise, Sematech has failed to achieve any major technological or product breakthroughs. Throughout the 1980s, US' global market share tumbled from 59% in 1980 to 39% in 1991 after bottoming out at 37% in 1988. In 1991, $20.9 billion worth of semiconductors were sold in Japan, $15.4 billion in USA, $10.1 billion in Europe and $8.2 billion elsewhere. American chipmakers have retreated up-market to more sophisticated microprocessors, while the Japanese dominate the memory chip market.

- **US and Japan - Trade liberalization agreements and resistance**

The Reagan and Bush administration efforts to open Japan's markets had a mixed success. After years of tough and sometimes bitter negotiations, Tokyo agreed to liberalize its orange and beef markets, but remains adamantly opposed to any concessions on rice.

One measure of the farm lobby's political clout is that Washington chose to spend enormous diplomatic resources on agriculture which comprises a small percentage of total bilateral trade when so many other American industries and technologies are struggling against Japan exports and allowed only a little share of Japan's markets.

Negotiations over Japanese import and investment barriers

Although negotiations were conducted over specific products, Washington also tried to address the problem of systematic Japanese import and investment barriers. Between 1988 and 1991, Washington and Tokyo conducted the Structural Impediments Initiative (SU), in which US cited examples of Japanese trade barriers such as the industrial groups (keiretsu), which tend to buy from each other, distribution cartels, highly subsidized agriculture, lack of patent protection, artificially high saving rates and so on.

On the other hand, the Japanese pointed out examples of US practices that inhibited economic growth such as low savings and investment, the large budget deficit, crumbling infrastructure and crime. Both sides promised to reform their respective systems. The USA fulfilled its promise under President Clinton when the budget deficit was finally eliminated in 1997 but the Japanese refused to end any of their neo-mercantilist strategies.

Tokyo vs. USA and the European Community

While USA fulfilled its promise, Tokyo meanwhile turned the tables on the US and the EC labeling them as "protectionists" and demanding that they remove their barriers. On June 1992, Tokyo released a report labeling the US as being the most unfair trader among the advanced industrial countries.

The report cited US tendency to impose unilateral and often protectionist decisions in bilateral trade disputes, unfairly use dumping laws to restrict imports, impose so-called voluntary export restraints on others and widely use "Buy American" (economic nationalist practices) laws. Tokyo claimed that Brussels was only slightly less protectionist than the US. Tokyo is increasingly turning to GATT and the WTO to help settle conflicts. Thus, as long as the imbalances between trade practices and results exist, there will be continued bitter conflicts.

The European Economic Community

Protectionism was most strongly expressed in the EEC which in 1982, at a GATT meeting, the EEC showed more reluctance than others to accept any curtailment of its freedom to exercise administrative discretion or make bilateral arrangements.

Also, political leadership also played a part in trade policies. In 1979, Thatcher's British Conservative Party ousted the Labour Party, in West Germany, Helmut Kohl, a Christian Democrat took over as chancellor while France was led by Francois Mitterand, a Socialist Party candidate. Whatever their ideologies were, they all responded with the same blend of defensive nationalism when economic conditions worsened.

It was interesting to note that different countries acted in support of much the same industries in the 1970s and 80s. For example, when the Multi-Fiber Arrangement was renewed in 1977, Britain and France were among the most active members of the EEC pressing for consideration of more stringent terms. For the steel industry both the USA and Western Europe also imposed quantitative import restrictions and market management.

Case study: US – EEC over the steel industry

USA was faced with the growth of an efficient steel industry against developed countries plus a matured market at home, the USA and Western Europe experienced recurrent bouts of excess capacity. By the 1960s, the USA already negotiated VERs with Japan and Western Europe, likewise Europe with Japan.

In 1977 when the steel market suffered a depression, the Carter administration introduced the "trigger price mechanism" and the EEC followed. The Reagan administration scrapped this in 1982 but the economy was still recovering, and US dollar still overvalued, thus the steel industry put pressure on the Reagan administration for quantitative restrictions.

The industry lodged a slew of cases against European producers, citing unfair trade due to dumping or subsidies. The EEC threatened to retaliate and USA despite its free market convictions, the US administration was obliged to negotiate VERs with Europe.

Weakening US political will and economic capacity to maintain free trade by the 1970s

Many fear that US' free trade policies are allowing the economy to be hollowed out as foreign competition undercuts American businesses while US MNCs transfer their operations overseas to enjoy access to markets, resources and cheaper labour.

Reasons

1. Stagflation

In the late 1960s economic growth of the US was slowing down, and it became visibly apparent in the early 1970s. Stagflation gripped the nation, and the government experimented with wage and price controls under President Nixon. The Bretton Woods Agreement collapsed in 1971-1972, and Nixon closed the gold window at the Federal Reserve, taking the United States entirely off the gold standard. President Gerald Ford introduced the slogan, "Whip Inflation Now" (WIN). In 1974, productivity shrunk by 1.5%, though this soon recovered. In 1976, Jimmy Carter won the Presidency, and would later take much of the blame for the even more turbulent economic times to come, though some say circumstances were outside his control.

Inflation continued to climb skyward. Productivity growth was pitiful, when not negative. Interest rates remained high, with the prime reaching 20% in January 1981. Unemployment dropped mostly steadily from 1975 to 1979, although it then began to rise sharply. This period also saw the increased rise of the environmental and consumer movements, and the government established new regulations and regulatory agencies such as the Consumer Product Safety Commission.

2. Chronic trade and budget deficits since the early 1970s.

Since the 1970s, the US has suffered huge annual deficits with most countries, especially with Japan and the EU. Their deficits with Japan and the EU have destroyed more jobs and bankrupted more companies than its deficits with China and OPEC. This is because China exports mostly low value toys and textiles whereas OPEC exports mostly oil in return for US manufactured products. In contrast, Japan and the EU sell high value manufactured goods such as automobiles, consumer electronics steel that provide high salaries to workers and high profits to companies. Thus, US trade deficits with those rivals clearly cost the US jobs and wealth.

3. The Vietnam War: High inflation

This loss by the US has been seen by some as a political defeat. As the number of troops in Vietnam increased, the financial burden of the war grew. One of the rarely mentioned consequences of the war was the budget cuts to President Johnson's Great Society programs. As defense spending and inflation grew, Johnson was forced to raise taxes. The Republicans, however, refused to vote for the increases, unless a $6 billion cut was made to the administration's social programs.

The Vietnam War claimed more than just victims overseas – at home it claimed reforms aimed at lifting millions of people out of poverty. Almost 3 million Americans served in Vietnam. Between 1965 and 1973 the United States spent $120 billion on the war. This resulted in a large federal budget deficit. The war demonstrated that no power, not even a superpower, had unlimited strength and resources.

4. Competition from other industrialized countries

Since the Tokyo Round in 1973, it was evident that despite some progress, agreements made then, the industrially more established countries remained unwilling to relinquish more than a modest portion of the considerable freedom they exercised to take unilateral action against specific imports. The completion of the Tokyo Round in fact in itself did nothing to arrest the erosion of confidence in multilateral trade. Japan has had a growth rate twice of US, ran immense trade and payment surpluses and has competed fiercely with the US in most industries and technologies.

5. Rise in protectionist barriers: Between developed and developing countries

Clinton failed to get Congress to re-approve the President's fast-track powers that bring trade treaties to a direct vote in both the Senate and House without being amended by special interest groups in the committees.

Despite Clinton's efforts, few other industrial and developing nations were willing to open their markets as widely was America's. Trade squabbles erupted among the industrialized countries. The WTO's conference at Seattle in November 1999 was a disaster as delegates deadlocked over measures that could further reduce trade and investment barriers while raising environment and labour standards, and anti-WTO riots raged outside

6. Resistance of US to free trade

Since the end of WWII, in part due to industrial supremacy and the onset of the Cold War, the US government has become one of the most consistent proponents of reduced tariff barriers and free 'managed' trade, having helped establish the General Agreement on

Tariff and Trade (GATT) and later the World Trade Organization (WTO). However, it did reject an earlier version in the 1950s (International Trade Organization or ITO).

Since the 1970s US government has negotiated numerous managed trade agreements, such as the North American Free Trade Agreement (NAFTA) in the 1990s, the Dominican Republic-Central America Free Trade Agreement (CAFTA) in 2006, and a number of bilateral agreements (such as with Jordan). At the same time, the US government has consistently opposed free trade in agricultural goods, subsidizing exports to the point where foreign producers (often in developing countries) are unable to compete.

It has also repeatedly failed to comply with the rulings of international trade tribunals (e.g. Canada US softwood lumber dispute). The US government has also made copyright and intellectual property legislation part of its free trade agreements.

Case Study: Government intervention through Section 301

US administration in the 1970s - 80s pressured by congressional demands, acted unilaterally and aggressively, threatening the foundations of multilateral trade cooperation. The US Congress developed on measures in 1974 to-penalize countries that were 'unreasonably' harming US trade by establishing the 1974 Trade Act that gave the president power to penalize countries that were deemed to have engaged in unfair trade. These included subsidies, dumping, government procurement, restrictive business practices.

Section 301 of the Trade Agreement Act of 1979 embodied these defensive actions to take but was tightened further by Congress as they felt section 301 was not forceful enough. Congress further created the Omnibus Trade and Competitiveness Act of 1988 and a provision known as `super' 301, which required the president to identify a priority list of unfair trade practices used in countries that would have to be eliminated within a specific time period. In fact, 301 was drafted to be consistent to US obligation to GATT thus countries could not claim USA was legally overreaching itself.

GATT was often unable to stop this as the procedure established for dispute settlement was weak and ineffective. This caused other countries to resent US pressure on them through GATT. USA thus was acting like judge and prosecutor and singling out countries for political and diplomatic action by USA. This has been perceived by other as USA as a leading trading nation using unilateral power to advance its own interests. Thus 301 was a threat to multilateral trade cooperation.

Case Study: NAFTA

The North American Free Trade Agreement NAFTA called off the majority of tariffs between products traded among the United States, Canada and Mexico, and gradually phased-out other tariffs over a 15-year period. Restrictions were to be removed from many categories, including motor vehicles, computers, textiles, and agriculture. The treaty also protected intellectual property rights (patents, copyrights, and trademarks), and outlined the removal of investment restrictions among the three countries. The agreement is trilateral in nature (that is, the stipulations apply equally to all three countries) in all areas except agriculture, in which stipulation, tariff reduction phase-out periods and protection of selected industries, were negotiated bilaterally. Provisions regarding worker and environmental protection were added later as a result of supplemental agreements signed in 1993.

The agreement was initially pursued by conservative governments in the United States and Canada supportive of free trade, led by Canadian Prime Minister Brian Mulroney, U.S. President George H. W. Bush, and the Mexican President Carlos Salinas de Gortari. The three-nation NAFTA was signed on 17 December 1992, pending its ratification by the legislatures of the three countries. Trade has increased dramatically amongst the three nations since NAFTA.

Case Study: US – Mexican Free Trade

Maquiladoras (Mexican factories which take in imported raw materials and produce goods for export) have become the landmark of trade in Mexico. From the earliest negotiations, agriculture remains a controversial topic within NAFTA, as it has been with almost all free trade agreements that have been signed within-the WTO framework. Agriculture is the only section that was not negotiated trilaterally; instead, three separate agreements were signed between each pair of parties. The Canada – US agreement contains significant restrictions and tariff quotas on agricultural products (mainly sugar, dairy, and poultry products), whereas the Mexico – US pact allows for a wider liberalization within a framework of phaseout periods.

The overall effect of the Mexico – US agricultural agreement is a matter of dispute. Some argue that the effects have been devastating to peasants, given that Mexico did not invest in the infrastructure necessary for competition (such as efficient railroads and highways). Some have argued that the North American Free Trade Agreement is actually not a "free trade" agreement, but rather is government managed trade. The essence of this criticism is that such trade agreements do not promote free trade; they inhibit it by implementing another level of bureaucracy on top of national governments.

Impact on Mexican farmers

Several studies have concluded that NAFTA has destroyed hundreds of thousands of agricultural jobs in Mexico. An influx of imports has decreased the prices for Mexican corn by more than 70% since 1994. As a result, of the 15 million Mexicans who depend on the crop, many can no longer afford basic health care and the labour demanded of them has been increased. NAFTA has been criticized for allowing U.S. agricultural subsidies to artificially depress corn prices. In 2000, U.S. government subsidies to the corn sector totaled $10.1 billion, a figure ten times greater than the total Mexican agricultural budget that year.

Case Study: US – Canadian dispute over softwood lumber imports

The United States and Canadian governments had a dispute over the United States' decision to impose a 27% duty on Canadian softwood lumber imports. Canada has filed numerous motions to have the duty eliminated and the collected duties returned to Canada. Canada has won every case brought before the NAFTA tribunal, the last being on March 18, 2006.

This presumed failure of the United States to adhere to the terms of the treaty has generated widespread political debate in Canada. The debate includes imposing countervailing duties on American products, and possibly shutting off all or some energy shipments, such as natural gas.

7. Poor US policies

Reagan's policies of tax cuts, increased spending and an overvalued dollar diminished American economic power by tripling the national debt and worsening the trade and payment deficits. The policies of Reagan also caused the decline of incomes of the middle and lower classes Americans.

8. Long term debt: creditor to debtor nation

This saw to the shift in the global economic power balance with US no longer holding the political and economic clout as it used to.

Challenge 4: Challenges from the Third World

Since 1950s, representatives from the Third World had been meeting to discuss their common problems and present a united front to the democratic industrial and communist blocs. Their aim was to forge a political economic alternative to the cold war rivalry.

The problems experienced by the Third World illustrates **two important points**:

1. The Golden Age of Capitalism did not have uniformed results across the globe as developing countries did not benefit as much as the developed countries
2. Principles such as trade liberalisation and institutions to promote free trade e.g. GATT, also had negative outcomes in the developing world.

The Non-Aligned Movement (NAM) was reinforced by regional organization like the League of Arab States (1948), Organization for African Unity (1963, OAU), ASEAN (1967) along with the UN Group of 77 (Third World countries) in the 1960s. Out of these, the G-77 has been most assertive, calling for international conferences to address trade and investment concerns.

Creation of UNCTAD

The creation of the **United Nations Conference on Trade and Development (UNCTAD)** challenged the developed world in many ways. Raul Prebisch, the first Secretary-General of UNCTAD tried to make it as an alternative to GATT, IMF and World Bank.

- UNCTAD, created in 1964, is the part of the United Nations Secretariat dealing with trade, investment, and development issues. The organization's goals are to: "maximize the trade, investment and development opportunities of developing countries and assist them in their efforts to integrate into the world economy on an equitable basis".
- UNCTAD was established to promote development among the so-called “un-developed” and “under-developed” newly independent countries; to facilitate the integration of these economies into the world economy.
    - When UNCTAD was created, the world was at the peak of the East-West conflict, and the South had emerged as an economic grouping of poor countries vis-à-vis the rich North. The member States of UNCTAD were arranged into groups reflecting these divisions: The Group of 77 (developing countries, further subdivided into regional groupings), Group B (developed countries), Group D (the then Central and Eastern European countries) and China.

- **UNCTAD was able to pressurize GATT to address many Third World issues**. In 1965, GATT issued a Part IV to its charter, allowing commodity price agreements and

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permitting Third World countries to opt out of the reciprocity cycle. However, Part IV stated that adherence by GATT members was voluntary.
- In addition to this focus on growth, early development thinkers in the 1950s and early 1960s considered the question of whether authoritarian government regimes, resulting from a multitude of political and historical factors, were better or worse for development than democracies. Their concern was that democracy might pose a “cruel dilemma”: namely, that democracies would be unable to raise domestic savings as rapidly as draconian regimes could.

General System of Preferences (GSP)

In 1968, after several years of negotiation, most of the advanced industrial countries agreed in principle to a General System of Preferences (GSP) in which they would reduce their barriers to Third World products. But it was not until 1971 that GATT approved the GSP by waiving its Most Favoured Nation reciprocity principle.

Assessment of GSP → The GSP engaged only in 1975 when 19 developed countries agreed to unilaterally eliminate tariffs for a decade-on a range of manufactured and semi-finished goods for 140 poor countries. The agreement last 10 years and was renewed in 1985. In the recent agreement, the USA has eliminated tariffs on $13 billion of imports from developing countries.

- Although GSP has helped Third World countries, developed countries have found ways to go around these concessions. They remove only barriers to Third World products that do not compete with their own. For example, the US excludes textiles and shoes as well as import sensitive steel, electronics and glass from the GSP and refuses to extend it to any OPEC country to any product that captured more than 50% share of US' market.

NIEO as a challenge to the developed world

During the 1970s, the G-77 reached its peak of activism and proposed in 1974 in the UN General Assembly to the creation of the **NIEO, New International Economic Order**. It got the United Nations General Assembly to pass the *Charter of Economic Rights and Duties of States* including sovereignty for all states, which means the right to use any wealth and resources in whatever way it wants. It also stated that it wanted the right to nationalize all foreign property and the right to create commodity cartels and the adherence of states to prices.

UNCTAD - the Integrated Programme for Commodities (IPC)

In 1976, UNCTAD inaugurated the IPC to help control fluctuations and the average price level for commodities. The IPC has attempted to negotiate such agreements for 18 commodities that comprise 755 of the Third World's commodities exports. Prices could be further managed by stockpiling and selling off when the prices rose too rapidly and buying more when the price fell.

- The IPC identified 10 of these stocks: rubber, sugar, tin, cocoa, coffee, copper, cotton and cotton yarns, hard fibers, jute and jute products. By 1980, UNCTAD granted the IPC a $400 million fund to finance these buffer stocks and another $350 million to help diversify Third World economies dependent on one or a fear of these commodities.
- **Assessment →** The IPC achieved limited success and by 1990s, there were only 5 international commodity agreements. These were undercut by nations like US, Australia Canada and South Africa who were important commodity exporters too.

__Cooperation from the developed countries__

The EU has been the most accommodating to Third World demands. Since 1975, Brussels has signed 4 agreements known as the Lome Conventions with 66 developing countries.

UNCTAD's influence and GATT

i) __Uruguay Round (1986-93)__

During this round, the less developed countries were put on a defensive by the industrial countries that they grant intellectual property-protection and reduce their trade barriers. Four industrial and nine Third World agricultural exporting countries known as the Cairns-Group joined together to pressure the EU to abandon agricultural trade barriers and export subsidies.

During this round there was a clear division between the First and Third World over technology. The developed countries believed that they had the right to protect their technology, or there would be no incentive for inventors to create new technology e.g. computer software.

- The Third World argued that technology should be used by all without restriction and that intellectual property protection perpetuated political economic supremacy of the developed and subjugated the poor. Although the Intellectual Property Organization (WIPO) was set up to address the problem of piracy, it has been unable to stem such thefts.

ii) Background to Third World demands

THIS SHOWS THE NEGATIVE IMPACT OF TRADE LIBERALISATION & GATT – OUTCOMES ARE NOT UNIFORMED ACROSS DEVELOPED & DEVELOPING COUNTRIES

Since GATT was created in 1947, less developed countries have sought favourable trade concessions from the less advanced industrial countries. Since the rise of Third world countries in the 1960s after decolonization, they have served to challenge the developed world.

Third World countries argue that **GATT's free trade and most favoured nations (MFN) principles actually harm rather than help their development.** Without trade barriers, Third World countries argued their few industries would be bankrupted by the much cheaper and better made products of the advanced industrial countries. The result would be economic stagnation and the development of underdevelopment rather than development as the Third World countries were forced to continue to rely on exporting commodities in which they have a natural-comparative price advantage.

Thus, the less developed countries requested for infant industry protection, the elimination of trade barriers with industrial countries and stable prices for Third World commodity exports.

Many of these demands were greatly opposed by Americans. GATT was intended as an interim measure and was more based of economic liberalism in which many less developed countries have since been lobbying for relief from its tenets. Another problem with GATT was that most negotiations involved eliminating barriers to manufactured goods rather commodities. Thus, Third World countries still find their commodity exports inhibited by relatively high tariff rates.

__Commodity exports losing value to consumer goods__

Another Third World complaint is that the commodity goods they export are losing their value relative to the consumer goods, equipment and other finished goods that they import. The average value of primary commodities imported as a percentage of the value of manufactured goods exported by developed countries has declined from 130 to 70 between 1957 and 1990.

In short, the industrial countries received almost twice as many primary goods for their manufactured exports in 1990 as they did in 1957, whereas Third World countries were receiving less than half the value for their commodity exports as they were 33 years before. Commodity prices have not only declined steadily in relative value over the last three decades but fluctuate sharply over the short term as they are traded on markets by investors. Both short and long term fluctuations in commodity prices can devastate countries that depend on one crop for most of their export earnings. About 85% of Cuba's export earnings come from sugar, 60% of Ghana's from cocoa, 50% of Bolivia's from tin, 60% of Sri Lanka's from tea, 65% of Hondura's from bananas and 50% of Zaire's from copper to name a few highly dependent economies.

Generally, the value of commodities decline was due to several reasons, ranging from industrial countries having found substitutes, e.g. saccharin for sugar thus hurting sugarcane producing countries The most important of these are that the industrial countries are major commodity producers. The United States, Canada, Australia and New Zealand produce grains, livestock and minerals. Due to their higher labour costs, these goods often are often more high prices than those from developing countries. Thus, these industrial countries have erected high trade barriers to protect their own less competitive commodity producers. In times of recession, the US, Europe and other developed countries tend to raise trade barriers, whereas Japan's trade barriers always shut out most competitive imports.

Discrimination against Third World commodities

PROTECTIONISM NEGATIVELY AFFECTED THE DEVELOPING WORLD MORE THAN THE DEVELOPED COUNTRIES – SHOWCASING THE DIVERSITY OF IMPACT.

Tariffs that are placed on commodities are often accompanied by other trade barriers, including strict labeling, health, and inspection standards. The result is to restrict Third World exports to commodities, rather than allow them to expand into semi-finished or manufactured goods.

GATT itself sometimes has blatantly discriminated against the Third World. In 1962, GATT negotiated the Long Term Arrangement Regarding Trade and Cotton Textiles (LTA) which allowed members to impose quotas and market share limits on cotton textile imports. The advanced industrial countries then negotiated bilateral agreements under the LTA.

- In 1974, under GATT, the Multi-Fiber Agreement (MFA) was signed between developed and developing countries creating a multi-quota system for textiles. In 1990, over 60% of the Third World yarn and textiles and 80% of clothing exports were restricted under MFA. If a free global textile market had existed, the World Bank estimated that it would increase textile manufacturing in Third World countries by 35% and create $1.3 billion in wealth for these countries.

Dependency and Conflict between the US and Third World

The Third World's political and economic fate is particularly tied to the US which usually absorbs 70% of Third World exports and almost 90% of Latin America's. To protect American jobs, Washington has often temporarily limited Third World products. For example, between 1975 and 1985, the US imposition of voluntary export restraints (VERs) on imports, many of which come from developing countries rose from 10 to 25% of total imports. When the US raised import barriers, the exports of the Third World suffered greatly.

Inevitably, almost everyone is hurt by protectionism. Recession in the Third World means less demand for American and other developed countries' products. With 40% of US exports going into the developing world, the US then loses potential economic growth.

Domestic demand for protectionism

Often governments cater to the political demands of important domestic industries and interests, regardless of the overall national interests. An industry may lobby or given campaign contributions in order to win special tax breaks, subsidies or restrictions on competing imports. Sometimes, states attempt to protect an infant industry as it starts up in the state for the first time, until it can compete on world markets.

Another motivation is to give a domestic industry breathing room when market conditions shift, or new competitors arrive on the scene. Examples of protectionism in developed countries are typically motivated by the desire to protect the livelihoods of individuals in politically important domestic industries. Whereas formerly blue-collar jobs were being lost to foreign competition, in recent years there has been a renewed discussion of protectionism due to offshore outsourcing and the loss of white-collar jobs.

The Tokyo Round failed due to disagreements between USA and the EEC over agriculture and textiles. Both sectors were highly resistant to open trade policies, Nixon like Kennedy had made promises to the textile industry in his 1972 re-election campaign. The outcome which had the active support of European governments was the Multi-Fiber Agreement. The USA protected some agricultural products such as cotton, sugar and dairy products but it also wanted to open up foreign markets for markets that it had a competitive advantage, such as wheat and beef. The EEC was bound to it Common Agricultural Policy (CAP) with its high protectionist barriers of import quotas and levies. For the EEC, the stabilization of rural production and incomes was politically more important than trade liberalization.

Case study: Bananas and Beef

In 1998, the US and the EU launched a trade war against each other over bananas that spread to the beef industry. This was an example of how politics influenced free trade idealism. The American headquartered Chiquita Bananas annually contributes millions to the Republican and Democratic parties. When the EU, to protect is own banana importers, limited Chiquita sales within its own borders, the corporation pressured the White House and Congress to retaliate. The US first took Chiquita's complaints to the WTO which issued three rulings against the EU.

In 1999, the WTO authorized the US to retaliate. Washington promptly slapped tariffs on $191 million worth of European imports to the US, the amount claimed to have been lost by America's banana exporters. The USA won another legal victory in December 1999 when the WTO ruled that US' Section 301 law, which empowers the president to retaliate against unfair traders, was legal. This was a blow against the EU and Japan, which had jointly filed a suit against Section 301, hoping to thus weaken a key in American defense.

Rather than resolve this issue, the two geo-economic superpowers joined battle over another product. The USA complained that the EU law against selling meat from livestock treated with growth hormones unfairly discriminates against American ranchers. The Americans claimed that there was no evidence that hormones caused cancer or other health problems. Here the US won a legal battle with the WTO ordering the EU to lift its ban. The EU announced that it would ban all US beef by June 15, 1999 unless the US promised not to sell hormone-laced beef.

Bananas and beef contribute at most $0.5 billion in an annual bilateral trade of $400 billion. Although the US suffered a worsening trade deficit with the EU that reached $35 billion in 1998, Europe's markets are largely open to US exports and investments. Special interests masquerading as national interests tend to distort trade policies. Beef and banana groups on both sides paid off politicians in return for trade protection. In this case, special interests prevailed over national interests.

Although the US and EU subsidize agriculture through a variety of means, the latter's farm welfare programmes are far costlier. Over half of the EU's $100 billion budget goes to the Common Agricultural Policy (CAP), which props up farmers with subsidies or payments and other protection, who would otherwise be bankrupted by international market forces. Although the EU trade policies are supposed to be determined by majority rule, in practice a consensus prevails. This gives special interests enormous clout in protecting themselves from international competition.

US special interests - American farmers, ranchers and other industries demanding corporate welfare are just as powerful getting tax cuts, subsidies and import protection

from Congress and the White House. Protectionist groups have asserted their power by getting Congress to refuse to renew the White House's fast-track, the president could negotiate agreements that Congress must either approve or reject without any amendments. This prevents special interests from destroying a treaty by getting their congressional representatives to protect them with corporate welfare provisions such as protecting them from the treaty's requirements.

Case study 2: USA and Japan over rice

The reduction of controlled items in the late 1980s resulted from Japan's loss of a GATT case brought by the United States concerning import restrictions on twelve agricultural products. In addition, heavy pressure from the United States led to an agreement that Japan would end import quotas on beef and citrus fruit in 1991.

The one restricted product that continues to prompt objections from other countries is rice, imports of which until 1994 were prohibited. Rice has traditionally been the mainstay of the Japanese diet, and farm organizations played upon the deep cultural importance as a reason for prohibiting imports. Despite such entrenched political and cultural opposition, foreign rice gradually found its way into Japanese markets and even on to the emperor's dining table by 1994.

Responses to the Challenges of the Third World

Use of non-tariff barriers by the US

<u>What are non-tariff-barriers?</u>
Another means to discourage imports are non-tariff barriers to trade. Imports can be limited by a quota. Quotas are ceilings on how many goods of a certain kind can be imported. They are imposed to restrict the growth of such imports. Non-tariff barriers to trade are trade barriers that restrict imports but are not in the usual form of a tariff.

They are criticized as a means to evade free trade rules such as those of the World Trade Organization (WTO), the European Union (EU), or North American Free Trade Agreement (NAFTA) that restrict tariffs. Some of the common examples are anti-dumping measures and countervailing duties, which, although they are called "lion-tariff" barriers, have the effect of tariffs but are only imposed under certain conditions. Their use has risen sharply after the WTO rules led to a very significant reduction in tariff use.

Non-tariff barriers may also be in the form of manufacturing or production requirements of goods, such as how an animal is caught or a plant is grown, with an import ban imposed on products that don't meet the requirements. Examples are the European Union restrictions on genetically-modified organisms or beef treated with growth hormones.

Some non-tariff trade barriers are expressly permitted in very limited circumstances, when they are deemed necessary to protect health, safety, or sanitation, or to protect "depletable" natural resources.

<u>Non-tariff barriers to trade can be:</u>

- State subsidies, procurement, trading, state ownership
- National regulations on health, safety, employment
- Product classification
- Quota shares
- Foreign exchange controls and multiplicity
- Over-elaborate or inadequate infrastructure
- "Buy national" policy
- Intellectual property laws (patents, copyrights)
- Bribery and corruption
- Unfair customs procedures
- Restrictive licenses
- Import bans

Economists generally agree that trade barriers are detrimental and decrease overall economic efficiency, this can be explained by the theory of comparative advantage. In theory, free trade involves the removal of all such barriers, except perhaps those considered necessary for health or national security. In practice, however, even those countries promoting free trade heavily subsidize certain industries, such as agriculture and steel.

The US government used quotas to restrict the number of Japanese made cars that could enter the US in the 1980s, when the US automobile industry was losing ground rapidly to Japanese imports. Most of the quotas were voluntary in that Japan and the United States negotiated a level that both could live with.

Impact of rise in non-tariff barriers by developed nations

As members of GATT, the developed countries had bound themselves not to raise tariffs. However, they all entered the 1970s with long practices in using non-tariff protectionist measures. This was seen for example under the Long Term Cotton Textile Arrangement

which became the Multi-Fiber Arrangement in 1974, alongside quotas on many agricultural products.

The past success of countries lowering tariffs was main reason why the Tokyo Round took place in 1973. As tariff barriers were lowered, traders became aware that national laws and regulations to trade presented numerous hindrances to foreign competition. The more government negotiated away their powers to utilize tariffs for protectionist purposes, the more they were urged to utilize other measures as alternate means of protection.

The Williams Commission (based on findings commissioned by Richard Nixon after US exports were underperforming in 1971), stressed that US exports were being hindered by foreign non-tariff barriers. It proposed multilateral negotiations to draw up codes of conduct on practices deemed restrictive of trade. This too was felt by Europe, who was frustrated by countries using non-tariff barriers to hinder the effects of tariff reductions. They wanted a return to issues raised during the Kennedy Round when the US administration had agreed to new rules relating to antidumping duties, in which the US Congress rejected claiming they did not have the authority to negotiate. Most Western European countries continued to make use of quantitative restrictions on imports of a number of products (e.g. cars) since WWII ended. The US placed restrictions on particular imports such as steel and petroleum. In the 1970s and early 1980s, the governments opened the floodgates to a spate of additional restrictions due to demands from individual domestic industries.

i) <u>Voluntary exports restraints (VERs)</u>

In the 1970s and 80s, a number of VERs were negotiated with exporting countries. Before the 1979s, only a handful of such VERs existed like textiles and apparel. However, by mid-1980s, the World Bank counted 90 such arrangements.

ii) <u>Government intervention</u>

Governments made great discretion in interpreting and enforcing national trade laws. In the EEC, the administrative interpretation of custom rules and procedures like local content requirement were used to restrict imports. An infamous case was a ruling by the French authorities that videocassette recorders could be imported into France only via the town of Poitiers, an inland town many miles away from the nearest Dort with very few custom officers. In the USA, national laws to unfair trade, in which the criteria were subjected to the discretion of the government, which was used extensively to deter foreign competition. For example, in the USA, the International Trade Commission had been asked to investigate imports that were subsidized soared to 600 in 1979-85 as compared to the trickle before that.

iii) <u>Subsidies</u>

One of the ways in which the government can protect domestic industry is through subsidies to a domestic industry which allows it to lower its prices without losing money. Such subsidies are extensive in but not limited to state-owned industries.

Subsidies can be funneled to industries in a variety of ways. A state can give tax breaks to any industry facing strong foreign competition or an industry struggling to get established. It can make loans (or guarantee private loans) on favourable terms to companies in a threatened industry. Sometimes governments buy goods from domestic producers at high guaranteed prices and resell them on world markets at lower prices; the European Community does this with agricultural products to the dismay of US farmers as does the US to the dismay to European farmers.

Critics of agricultural subsidies argue that they promote poverty in developing countries, by artificially driving down world crop prices. Agriculture is one of the few areas where developing countries have a competitive advantage. This makes developing countries into dependent buyers of food from wealthy countries, causing local farmers to lose their land rather than allowing them to develop their own agriculture and therefore self-sufficiency.

There was a significant difference of opinion between the US and Europe on subsidies. The USA complained that European governments provided extensive subsidies to individual industries either directly or through state ownership. The Europeans countered the huge US public expenditure on armaments and aerospace industries were, in effect, subsidizing the technological research and development that gave the US the competitive edge.

Difference in opinion over the relationship between the state and private enterprise was an issue as well. One saw subsidies as a legitimate instrument of state-directed industrial policy while the other believed that the state showed allow the market to determine industrial performance.

Agricultural subsidies often are a common stumbling block in trade negotiations. In 2006, talks at the Doha round of WTO trade negotiations stalled because the US refused to cut subsidies to the other countries' desired level.

<u>Some other non-tariff barriers</u>

i) Valuing of imports

In the Tokyo Round, some issues were raised on codes of conduct on trade practices, one being the method used by customs in valuing imports for levying duties. The complaint was that the method was not uniform, thus a new code was formulated.

ii) Meeting technical requirements

Difficulties were also faced in meeting the technical requirements laid down by national authorities for e.g. in electrical appliances. The new code sought to harmonize the standards and methods.

iii) Anti-dumping duties

There was also little progress made in this area due to government reluctance to redraft rules that would restrict their room for maneuver.

iv) National security purposes

One motivation of protecting an industry is when it is considered vital to national security. In the 1980s, US officials sought to protect the US electronics and computer industries against being driven out of business by Japanese competitors. A government sponsored consortium of US computer chip companies called Sematech was formed to promote the US capability to produce the chips cheaply.

Autarky (self-reliance, for a state to be self-sufficient) may not pay in most economic activities but for military goods states are often willing to sacrifice some economic efficiency for the sake of self-sufficiency. In the event of war, the state will be less vulnerable.

Impact of protectionism

Protectionism can have both positive and negative effects on an economy, most often helping producers but hurting consumers.

- **Positive impact**

Although protectionism violates liberal principles, temporary protectionism can have a stabilizing effect under certain conditions. When US motorcycle manufacturer Harley Davidson lost half its US market share in four years, the US government imposed tariffs on imported Japanese motorcycles. The tariffs started at 45% in 1983, they were to decline each year for five years and then to be eliminated. As a result, Harley regained its market share and tariffs were lifted a year later. In the late 1980s, a reinvigorated Harley raised its market share even more and began exporting Harleys to Japan.

Protectionism policies worked in this case because it was short term and straightforward. Most protectionist policies are longer term, more complex and likely to backfire.

- **Negative impact**

Although US automobile manufacturers were aided by the restrictions imposed on Japanese imports in the 1980s. The US automobile consumers paid more for the cars as a result. Another problem is that domestic industry may use protection to avoid needed improvements and may therefore remain inefficient and uncompetitive, especially if protection continues over many years.

- **More comprehensive measures to promote self-help**

The World Bank provided a small element of aid, but the Third World was unhappy over international organizations acting on the interest of developed countries especially USA. They demanded measures to promote self-help through changes commercial policies rather aid with strings attached. They also enjoyed a majority vote at the UN and were not without political influence. Thus in 1964 in Geneva, they created UNCTAD (United Nations Conference on Trade and Development), a permanent organization for themselves to press their demands.

In 1967, the Group of 77 of the non-aligned states devised a Charter which in 1974 became the `Charter of Economic Rights and Duties of States'. Predictably, the Charter favoured developing nations, rather than developed ones. These rights include loans, grants for the Third World, preference for their manufactured exports and favourable prices for the primary goods imported from them. They also wanted subsidies if world prices moved against them. They also wanted international monetary reform in their interest, the regulation of transnational companies and regularized transfer of technology from advanced nations to themselves.

- **Resistance from industrialized countries**

The industrialized countries were not willing to make concessions, accepting the principles of the "New International Economic Order' (NIEO) devised in 1973 and agreed in principle to set aside 1% of their GNP for aid to the Third World. However, the industrialised countries were put off by the aggressive rhetoric and confrontational tactics of UNCTAD. It became clear that whatever proposals the Third World countries put

forward amounted in the end to a transfer of resources from themselves to the developing countries with nothing offered in return.

- **Dependence on aid**

Non-government organizations - International aid meanwhile reached the poorest countries in numerous ways: Examples include Oxfam and the Red Cross. In times of crisis, like Ethiopian famines, additional funds would flow from public collections. The UN also started their own development programme, UNDP, in 1965.

- **Corruption**

There have been criticisms that much aid ended up in the pockets of corrupt governments, were used to keep tyrants in power or worse-they were used to acquire arms to oppress the people.

- **Development assistance**

Besides grants, development assistance took various forms. Between 1970 and 1983, such assistance amounted to $36 billion of which the industrialised market economies provided 76%, OPEC countries 15% and USSR and Eastern Europe 9%. The USA was the leading donor nation. In terms of receiving countries, the largest contribution went to Africa.

Challenge 5: Causes of the debt crisis[1]

In 1970, the fifteen heavily indebted nations (using the World Bank classification of 1989) had an external public debt of $17.923 billion - which amounted to 9.8 percent of their GNP. By 1987, these same nations owed $402.171 billion, or 47.5 percent of their GNP. Interest payments owed by these countries went from $2.789 billion in 1970 to $36.251 billion in 1987. **Debt service, defined** as the sum of actual repayments of principal and actual payments of interest made in foreign currencies, goods, or services on external public and publicly guaranteed debt, accounted for 1.5 percent of their GNP and 12.4 percent of their exports of goods and services in 1970. In 1987, those figures had risen 4.3 percent and 24.9 percent, respectively.

Table 17.1 / Selected Debt Statistics of the Fifteen Most Severely Indebted Developing Nations

	Total External Debt (Millions Of $US) 1990	*Total External Debt (as a % of GNP)* 1980	*Debt Service (as a % of Exports)* 1980	1990
Algeria	26,806	47.1	27.1	59.4
Argentina	61,144	48.4	37.3	34.1
Bolivia	4,276	93.3	35.0	34.1
Brazil	116,173	31.2	63.1	20.8
Bulgaria	10,927	1.1	0.3	56.9
Congo	5,118	98.0	10.8	20.7
Cote d'Ivoire	17,956	58.8	28.3	38.6
Ecuador	12,105	53.8	33.9	33.2
Mexico	96,810	30.5	49.5	27.8
Morocco	23,524	53.3	32.7	23.4
Nicaragua	10,497	112.1	22.3	4.1
Peru	21,105	51.0	46.5	11.0
Poland	49,386	16.3	17.9	4.9
Syria	16,446	27.1	11.4	26.9
Venezuela	33,305	42.1	27.2	20.7

Source: World Bank, *World Development Report, 1992* (Washington, DC: The World Bank, 1992) Tables 21 and 24, pp. 258-259, 264-265.

i) **Increased borrowing by developing countries:**
When funds reached the Third World in the form of loans, they would have to be repaid in due course in addition to the interest payments usually payable from the start. While different agencies including local authorities may be responsible for these payments, in

[1] The "debt crisis" will refer the external debt, both private and public, of developing countries, which has been growing enormously since the early 1970s.

the end it was the economy as a whole which had to earn a current surplus in foreign currency to meet those obligations to the foreign creditors.

Where the loans were well used and conditions in the world markets were favourable, the production derived from the capital investment created by the original loans should have provided that surplus and excess. When the money had been used wastefully, no surplus arose, and the country was faced with the need to find foreign currency to service the loan on top of its original difficulties.

Unless there was to be a never-ending, ever-increasing stream of capital loans from abroad, the outflow to service the borrowed capital, including interest and repayments would exceed the incoming stream of foreign investment to the borrowing country. So, here was a time bomb waiting to explode as the total outstanding external debt of the developing countries increased inexorably from $636 billion in 1980 to $1,017 billion in 1985.

ii) Impact of the 1973 and 1979 oil crises: availability of petrodollars
While the above point was a time bomb ticking away, other factors combined caused the explosion in 1982, the year of the world debt crisis. The 1980 debt crisis was caused by several interrelated problems of which the most important was OPEC's fourfold increase of oil prices in 1973 and further doubling in 1979. As a result, there was a huge shift in wealth from poor countries to OPEC.

Due to the oil crises in 1973 and 1979, saw to the emergence of petrodollars that went into the hands of oil producing countries which lacked the adequate investment opportunities at home. Since these countries lacked the sophisticated banking infrastructure, they deposited their money in western banks.

However, as the economy was stagnant, banks had problems finding borrowers in which the banks became desperate. Many of these 'petrodollars' were recycled back to the Third World and soaring oil prices saw Third World countries sank deeper into debt. The Third World's debt rose from $100 billion in 1973 to $831 billion in 1982 and $1.3 trillion in 1988. They were therefore almost forcing their loans on to middle-income countries such as those in Latin America.

At the same time, developing countries, faced with prices of oil and other imports which were rising fast than their export prices to their terms of trade deteriorating by 23% between 1980 and 1985. They were only too eager to absorb foreign loans to bridge the gap. The availability of petrodollars created a binge of lending by banks and Third World countries borrowed more than they could repay. There appeared to be no limits to the banks' willingness to extend credit and the borrowers to take it.

By the mid-1980s, the consequences were a staggering debt of $500 billion for Latin America and Africa. Many were staring at bankruptcy and if they defaulted, they threatened to take the lending institutions and international banking system with them. Interest rates began to rise, causing serious strain on the annual payments stream. The share of the export earnings which had to be diverted to service the debt for all developing countries together rose from 16% in 1977 to 25% in 1982 which in turn made the current balance deteriorate even more.

iii) Drying up of petrodollars

The Organization of Petroleum Exporting Countries pumped more than oil into the world economy during the 1970s. OPEC also poured billions of dollars that it collected from oil buyers into Western banks operating in the Euromarket, the hub of international finance. Those institutions then lent the funds to borrowers that ranged from Third World governments to multinational corporations. This so-called petrodollar recycling was a major source of cash for world money markets during the past decade.

However, falling oil revenues turned OPEC from a lender into a borrower and OPEC was drying up an important pool of money. This raised interest rates around the world and put a further squeeze on cash-starved developing countries and the Eastern European nations that were already having trouble getting loans.

OPEC had built up financial holdings worth some $360 billion in the decade of oil shortage, but that amount had now decreased. Although oil prices had dropped in recent months, OPEC members did not sharply cut back on their expensive development programmes. As a result, OPEC incurred a deficit in 1982 of between $25 billion and $30 billion. Not every member of the group (OPEC) borrowed money. Small states like Kuwait and the United Arab Emirates remained comfortably in surplus, but hard-pressed countries with large populations, such as Nigeria and Indonesia, faced significant deficits. It was estimated that Nigeria and the other populous OPEC nations had to sell off assets worth some $25 billion and then still have to borrow about $5 billion from banks.

The West was confident that they would be able to handle the problems of fewer petrodollars and new OPEC borrowing. They pointed out that the principal and interest due in 1982 on all bonds issued in the European market came to $24 billion, which dwarfed the amount of OPEC borrowing. Moreover, the $1.5 trillion Euromarket was no longer as dependent upon OPEC money as it once was. While most of its new funds were previously supplied by the oil producers, the market was now so large that it could satisfy

most of its new capital needs. Finally, the deep worldwide recession has reduced the demand for funds.

iv) US Economic Policies

The steep increase in interest rates[2] in the United States of America to combat inflation at the turn of the decade triggered debt crises in many countries of Latin America and Africa. Highly indebted countries in those regions were unable to repay the debt, as debt service payments rose sharply.

- Moving from negative values in the 1970s, real rates in the United States reached 3.9 per cent in 1980-1982 and 6.7 per cent in 1983-1987. For developing countries, this meant higher costs of borrowing, reduced demand for their exports and limited growth of foreign concessional assistance.
- What triggered the debt crises in the 1980s was the decision taken by the Federal Reserve Board of the United States in October 1979 to raise interest rates steeply. That decision came to be known as the "Volcker shock," bearing the name of the then Chairman of the Federal Reserve, Paul Volcker. It had a direct impact on debt service, since much of the external debt in developing countries had been contracted at floating interest rates. The difficulties were compounded by a sharp drop in non-oil commodity prices.

v) Reduced export earnings of developing countries

- **Africa**

In the West, the oil crisis contributed to global recession which in turn lessened the demand for raw materials. In the case for Africa, the prices of copper, bauxite (aluminum ore) and diamonds fell. Prices for agricultural exports fell as a result of world surplus. The glut in agricultural commodities played havoc with the African economies. Cacao, coffee, cotton, and peanuts no longer brought prices African exporters had been accustomed to. After 1979-1980, prices for African commodity exports declined by as much as 30% while the prices for crude oil and goods manufactured in the West such as machinery, tools, electronics and weapons continued to rise.

The appreciation of foreign currencies, especially the US dollar added to the problems of Africa. Since debts by nations were calculated in US dollars, the increasing purchasing power of the dollar in the early 1980s played havoc with the pay rate of debtor nations. Debts now had to be repaid in dollars with greater purchasing power; this meant that Third

[2] By 1980, developed countries had begun to adopt restrictive monetary policies aimed at reducing inflation, which led to high nominal and real interest rates, especially in the United States.

World nations had to export more. In effect, this condition forced African governments to repay more than they borrowed.

- **Latin America**

In Latin America, countries were dependent on agricultural exports and the rapid increase in oil prices in the 1970s and the drop in agricultural commodity prices produced a sharp decline in the standard of living.

vi) Increase in US and world's interest rates

In 1985 alone, African nations were required to pay $7 billion to banks and governments of the developed world. On average, African nations used 25% of their foreign currency earnings to repay foreign debts. They were reaching a point whereby they were dismantling their social and economic development plans to meet their debt obligations. They were damaging their economies to meet their interest payments.

When the world economy went into recession in the 1970s and 80s, and oil prices skyrocketed, it created a breaking point for most countries in the region. Developing countries also found themselves in a desperate liquidity crunch. Petroleum exporting countries — flush with cash after the oil price increases of 1973-74 — invested their money with international banks, which 'recycled' a major portion of the capital as loans to Latin American governments. As interest rates increased in the United States of America and in Europe in 1979, debt payments also increased making it harder for borrowing countries to pay back their debts.
While the dangerous accumulation of foreign debt occurred over a span of years, the debt crisis began when the international capital markets became aware that Latin America would not be able to pay back its loans.

vii) Default of Latin American countries

The crisis had its center in Latin America. Unlike other countries in the Far East and Europe, which reacted to the oil crisis by tightening their belts, the Latin American governments did not cut back on consumption but instead borrowed to keep going at the old rate. The Third World leaders had themselves to blame for much of the borrowed money was squandered, some landed in Swiss Bank accounts other pursued grandiose construction projects. Little was invested in production or infrastructure that would stimulate national growth.

In the mid-1980s, oil prices dropped to half their former price as new non-OPEC production in China and Mexico began. Although this relieved pressure on non-oil producing nations, now the oil-rich but heavily populated countries such as Mexico,

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Theme II: Understanding the Global Economy
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Nigeria, and Indonesia began to borrow heavily to maintain huge development projects that they had embarked on since the 1970s. The external debt of the government sector in all Latin American countries rose tenfold between 1973 and 1983, while their private sector debt rose fourfold.

As their budgets went out of control, hyperinflation followed in several of the larger countries. A massive flight of capital was the consequence: thus, Mexican assets held abroad rose from $3 billion in 1973 to $64 billion in 1984, equivalent to the whole of the country's official foreign debt. In Argentina, capital outflow was equal to 60% of the increase in indebtedness in 1979-81. In Venezuela, it was equal to more than 100%. Basically, the governments in the region as well as their richer citizens had acted with exceptional irresponsibility.

The Default of Mexico: explosion of debts

In the 1960s and 1970s many Latin American countries, notably Brazil, Argentina, and Mexico, borrowed huge sums of money from international creditors for industrialization; especially infrastructure programs. These countries had soaring economies at the time, so the creditors were happy to continue to provide loans.

The crisis was triggered by the default of Mexico, up to then, considered one of the safest debtor countries: it ran out of foreign currency in August 1982. Other countries followed in rapid succession. Much of the less cautious lending had be done by private banks whose share in Latin American indebtedness had risen from 11% in 1965-6 to 56% in 1979-80. Since these loans were not by government agencies, so the debts could not be written off as a gesture of political goodwill.

Background to problems

The oil shortages of the 1970s did not harm Mexico, as Mexico's oil reserves were potentially the world's largest. The problems of Mexico were caused by its large and rapidly growing population; weak industrial base and inefficient agricultural system which its oil had promised to solve its problems.

It borrowed large sums of money in the expectation that oil shortages and high oil prices would make it possible to repay the loans. In short, Mexico borrowed against future income. At the end of 1981, Mexico's foreign debt was about $55 billion and in 1985, it was $100 billion.

Mexico defaults

In 1982, Mexico announced that it would suspend interest payments to foreign lenders and the fear grew that if Mexico defaulted, other debtors would follow. This would devastate the global financial and trading system. Brazil, Mexico, Argentina, Venezuela, and Chile defaulted, and US bankers were especially vulnerable because they owned 40% of Latin America's total debt.

The IMF helped managed this crisis by organizing an advisory committee that would negotiate directly with that government. The government in return (represented all the country's debtors) worked with the IMF, World Bank, industrial country governments and commercial lenders. Within 2 days of Mexico's default, USA lent $2 billion to Mexico and pressured banks to reschedule payments.

IMF and Mexico began to work out a more comprehensive scheme; in return for a loan from IMF, Mexico agreed to an intensive austerity programme which it devalued its currency, reduced government spending, cut back its subsidy programmes. Other debtors soon followed suit and Brazil asserted its inability to meet interest payments. By 1983, 25 countries with over $200 billion in debts had their loans rescheduled by their lenders. By following the IMF prescription, most of these countries made progress and within a year, Mexico and Brazil converted a payment deficit to surplus and were able to continue financing their loans.

Rejection of IMF by other countries: debtor's cartel/The Baker Plan

In 1984, Argentina threatened to reject IMF's austerity plan, but eventually relented under the pressure of Mexico and Brazil. The following year, US Treasury Secretary Jim Baker announced a plan before the World Bank and IMF that targeted 15 indebted countries for debt rescheduling. In return these countries had to receive IMF's programme. The Baker Plan, as it was known, took some time to take off and IMF in 1988 cut back new lending. Overall, the debtor countries gave back more money to the global lenders than they received.

Debt crisis unresolved

Many Third World countries remained trapped in a vicious economic cycle as they spent more money abroad in interest payments than they received in loans, aid or export earnings. The more money governments diverted to pay interest on their debt, the less money they had to invest in export industries that could earn money. Unable to keep up with the interest payments, governments borrowed yet more money and sank further into debt and poverty.

Economic stagnation often led to political instability – food riots, coups, communist insurgencies that further gutted the economy. Those who had money rather send it to overseas safe havens than invest it locally. The Third World debt varied from region and country, essentially the numbers who were living in absolutely poor conditions rose from 650 to 730 million.

Failure of the Baker Plan

Unable to deal with the growing problems, there was pressure on global bankers especially USA to come up with a less stringent plan and 1989, US Treasury Secretary Nicholas Brady announced a more liberal plan. The goal was to reduce Third World debt burden by 20 % over the next 3 years.

How the debt crisis was resolved?

i. Help of IMF

Immediate help was offered by IMF but in the longer term the problem was solved by 'rescheduling' of debt. This meant a reduction in the interest rates payable and a lengthening of the repayment period so that the annual burden was lightened. It also commonly involved new lending to get through a critical transition period. In 1982, over twenty countries were renegotiating and by the end of 1983, 17 Latin American countries had adjustment agreements with IMF.

ii. World inflation

Latin America had accounted for about 40% of the outstanding debt by developing countries. Overall, the debt crisis was overcome by little sacrifice by the banks and it was eased in part by world inflation which lowered the burden on the debtors. But it imposed hardships on the citizens of the poorer nations.

Conclusion

By the late 1980s, confidence was returning in strength to lead to a new bout of international lending, followed by more difficulties among debtors. By 1993, with $1.6 trillion of loans outstanding to the Third World, arrears of interest and capital repayments had risen to $86 billion from $44 billion in 1987. The poorest nations of Africa and South Asia posed the greatest problems, having the heaviest debts servicing burdens. Thus in 1990, 30.9% of Indonesian exports went to servicing the foreign debt, in India it was 26.8% and in Bangladesh 24.5%. Africa owed less than 10% of the total debt in 1993 but accounted for 40% of the unpaid arrears.

In 1995, the world had to deal with another Mexican debt crisis. Rescheduling was needed again and a 'London Club' for commercial banks was paralleled by the IDA Special Debt Reduction Facility of 1989 and by the 'Paris Club' of richer nations. These arranged 64 schemes between 1990 and 1993 to carry out rescheduling.