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Paper : International Trade Law

Module : Introduction to International Trade Law

ज्ञान-विज्ञान विमुक्तये

Role	Name	Affiliation
Principal Investigator	Dr. Ranbir Singh	Vice Chancellor, National Law University, Delhi
Co-P.I	Prof. Dr. G.S. Bajpai	Registrar, NLU, Delhi
Paper Coordinator	Dr. Saloni Khanderia-Yadav	National Law University, Delhi
Content Writer/Author	Prof. A. Jayagovind	National Law University, Delhi
Content Reviewer	Dr. Sheela Rai	National Law University, Orissa
Language Editor	Dr. Saloni Khanderia-Yadav	National Law University, Delhi

DESCRIPTION OF MODULE

Items	Description of Module
Subject Name	Law
Paper Name	International Trade Law
Module Name/Title	Introduction to International Law
Module Id	1
Pre-requisites	• Economics of international trade, • The theory of comparative advantage, why countries trade with each other, • Arguments for and against free trade
Objectives	To understand the following: • The origins of international trade law; • An analysis of comparative advantage vis-à-vis absolute advantage; • An over-view of the GATT and the WTO in regulating International Trade Law.
Keywords	GATT, Protocol of Provisional Application.

E-TEXT:

Topics and Sub-Topics covered:

Introduction

Historical Background

Economic Theories

Developing Countries and Free Trade

Strategic Trade Policy

Conclusions

INTRODUCTION

International Trade Law (ITL) is the law regulating international commerce. It has two aspects: public and private. The public aspect of ITL seeks to coordinate commercial policies of states; and it is a part of Public International Law. The private aspect of ITL governs international commercial transactions between the people belonging to different states. This is substantially covered under Private International Law. In addition, the bodies like the United Nations Commission on International Trade Law have been trying to develop standard laws on various aspects of transnational transactions and states are expected to incorporate them in their respective legal system. This process is known as unification of laws. In this module, only public aspects of ITL are covered.

The purpose of ITL has been to foster free trade among nations. Free trade in this context means that people should be free to buy and sell goods cutting across national frontiers. In other words, a person should be free to buy a product from anywhere in the world wherein he can get the best quality at the cheapest possible price. Similarly, he should be free to sell his product anywhere in the world at the highest possible price. In brief, it is the globalization of Article 301 of Indian Constitution: Trade, Commerce and intercourse shall be free throughout the territory of India.

Before the emergence of modern state system in 17^{th} century, trade was free and merchants moved all over the world to the extent they could buying and selling goods and incidentally spreading knowledge and culture. In this way, they were the harbingers of modern civilization. But once the organized state system came into existence, the governments started interfering into these commercial transactions. To start with, they began to levy tariffs on incoming goods mainly with a view to bolstering their revenues. With the ushering in of Industrial revolution, manufacturing became an important component of national economy. At that stage, states started using tariffs and other devices to protect national economy from foreign competitors. From that time onwards, free trade and protectionism moved side by side: one following the other like a shadow.

Thanks to the contributions of people like Adam Smith, the governments realized the value of free trade; and made conscious efforts to promote free trade. One can identify three distinct stages in the evolution of international free trade regime. To begin with, states started concluding bilateral treaties, with a view to mutually reducing tariffs with regard to certain specified goods which were of interest to them. Anglo-French Treaty of 1860 was the earliest bilateral treaty calling for a "tariff truce" and aiming at mutual tariff reductions. And this stage continued up to the end of Second World War.

By the end of Second World War, having realized the limitations of bilateral approach, the states went for a multilateral approach for the first time. The General Agreement on Tariffs and Trade was the product of this approach. The principle of non-discrimination along with tariff reduction became the basis for this new multilateral regime. The principle of non-discrimination means that states shall not discriminate between goods by reference to their places of origin.

Thanks to the emergence of multinational corporations and global production chains, national economies are being globalized. Modern digital technology made the integration of production at global level possible. The European Union, the North American Free Trade Area and the World Trade Organization represent the institutional manifestation of this new trend. Along with trade liberalization, these institutions have been pursuing the objective of developing global standards and thereby global governance for intellectual property rights, investment, labor rights, etc. There have been formidable obstacles on the way, but still the effort towards a global regime in trade, investment and related aspects such as technology is going on. Trans-Atlantic Trade and Investment Partnership (TTIP), Transpacific Partnership Agreement (TPPA) and Regional Comprehensive Economic Partnership (RCEP) represent this renewed effort. The basic idea seems to be that even if global consensus is not possible, let us try at substantial regional level.

HISTORICAL BACKGROUND

The General Agreement on Tariffs and Trade (GATT), the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBAD) were established to provide institutional framework for post-War international economic order. They were planned as response to economic problems that afflicted international economy during inter-War period. Soon after the First World War, the League of Nations was established to foster multilateral approach towards international problems. Though the League did not have a separate set up to deal with international economic problems, its Secretariat made significant intellectual contribution to the analysis of economic problems. The first World Economic Conference was held under the under the League's Auspices in 1927; and it produced Geneva Convention on Import and Export Prohibitions. This was the first multilateral effort to establish a legal regime for international trade. The Convention prohibited quantitative restrictions on international trade except for balance of payments purposes. Though it was signed by large number of states, there was no adequate ratification. Hence it did not come into force.

In the early 1930s, international economy was hit by the Great Depression. States reacted by imposing restrictions on incoming goods, hoping that they would thereby protect domestic employment. The U.S. Congress passed Smoot-Hawley Act in 1930 whereby import duties were raised considerably. Other states reacted in the same way; and beggar-my-neighbor policy became the order of the day. Between 1929 and 1934, international trade shrank by 2/3.

When the USA realized that it could not sell its products any longer in international market, it tried to get out of it by concluding bilateral trade agreements with other countries whereby the parties mutually reduced the tariffs on selected products. The U.S. Congress passed Reciprocal Trade Agreements Act in 1934, authorizing the

President to conclude bilateral trade agreements for certain period of time; and when that time expired, it renewed the authority a couple of times. The fast track authority, so given to the President was used by the latter to enter into the GATT.

The U.S.A. concluded a number of reciprocal trade agreements with other countries. All of them invariably contained so-called conditional most favored nation clause. For example, country A would give most favored nation treatment to certain goods coming from B provided B reciprocates this gesture. Thus both A and B would extend to each other most favored nation treatment on reciprocal basis. But this kind of bilateral approach had its own limitations. Thus when the countries started negotiations for the establishment of International Trade Organization, there was general consensus on multilateral approach based on unconditional most favored nation treatment.

In 1939, the Second World War broke out. Many scholars are of the view that economic misery, caused by the Great Depression facilitated the rise of totalitarianism in Germany and Italy. The Allied Powers fought the War against the Axis Powers under the slogan of protecting democracy from the onslaught of totalitarianism. Even as the War was raging, the Allied Powers started the deliberation on new World order which would secure the World peace. The Atlantic Charter, agreed between the USA and the UK, was the first step in this direction; and this Charter, inter alia, emphasized free trade. Free trade among free people was the guiding ideology for the reconstruction of war-ravaged world. The United Nations Organization was established in 1945 to advance the cause of human rights and fundamental freedoms. Free trade which is the expression of economic freedom was considered as the fortification of liberal world order. As Cordell Hull, the leader of the U.S. delegation to the ITO negotiations, put it:

> Enduring peace and welfare of nations are indissolubly connected with friendliness, fairness, equality and maximum degree of freedom in international trade. Unhampered trade dovetails with

peace and high tariffs, trade barriers and unfair competition with War.

By the end of 1945, the U.N.O., the IMF and the IBRD came into existence. The negotiations for the International Trade Organization (ITO), the trade component of post-War international economic order, started in 1946. The Economic and Social Council passed a Resolution, on the initiative of the U.S.A., convening a U.N. Conference on Trade and Employment. A Preparatory Committee, consisting of 19 countries, was set up to prepare the background materials for the proposed Conference. A U.S. proposal with inputs from the U.K. on International Trade Organization provided the basis for the deliberation of Preparatory Committee. The Preparatory Committee held 3 meetings: in London in October, 1946; in New York in January, 1947 and in Geneva during April-October, 1947. The final U.N. Conference on Trade and Employment was held during November 1947 and March 1948 and it produced the U.N. Convention on Trade and Employment, popularly known as Havana Charter.

The main interest of the U.S.A. in ITO negotiations was the opening up of markets for its surplus products. It insisted on parallel negotiations for the reduction of tariffs. Given the prominence of the U.S.A., other countries could not resist this demand. In Geneva meeting, 45000 tariff concessions worth $ 10 billion were negotiated between 23 countries. 1947 was a crucial year for the negotiators. The U.S.A. realized that the negotiations for the ITO were moving much against its ideas; and hence there would be a likelihood of stalemate. Further, by the end of 1947, the fast track authority, given to the President under the Reciprocal Trade Agreements Act, would expire; and it was unlikely that the Congress would extend this fast track authority, given its hostility towards free trade policies in general. Under these circumstances, the U.S. delegation took out certain portions of the ITO charter in making, especially from Part IV dealing with "Commercial Policies" and produced the General Agreement on Tariffs and Trade (GAT) in order to provide the legal backing to the tariff concessions already negotiated in Geneva meeting and also to provide a legal framework for future negotiations. The expression "Tariffs" in the title "The GATT" indicates the main concern of the U.S.A in undertaking this exercise.

The GATT was essentially conceived as a stop-gap arrangement pending the establishment of the ITO. Article XXIX of the GATT dealing with the relation between the GATT and the proposed Havana Charter makes this point clear. Therefore, the participant states thought of adopting the GATT provisionally through a protocol. Accordingly, a Protocol on Provisional Application was drafted, and the idea was that by accepting this Protocol, the GATT would be operationalized. The Protocol contained two important provisions:

1. Part I and III of the GATT shall be accepted by all the Contracting Parties;

2. Part II of the GATT shall be accepted "to the fullest extent not inconsistent with existing legislation.

The Protocol also provided in its Preamble that the GATT would "apply provisionally on and after 1st January 1948" provided the following eight Governments sign the Protocol not later than 15 November 1947. These eight Governments were: Australia, Belgium, Canada, France, Luxembourg, Netherlands, the U.K. and the U.S.A. All of them signed before 15 November 1947. Many other countries joined the GATT later on.

Part I of the GATT consisted of Articles I and II providing for most favored nation treatment and the Schedule of Concessions. Part III, consisting of Articles XXIV to XXXV, mainly dealt with procedural issues including Tariff Negotiations, i.e. Article XXVIIII bis. Part II of the GATT consists of substantive obligations such as national treatment, trade remedies, quantitative restrictions etc. The interpretation of the clause in the Protocol: "the fullest extent not inconsistent with existing legislation" was controversial even at that time. It was popularly called as "grand father clause" in the sense that it protected the existing rights of states. But a contracting state is prevented from enacting legislation contrary to the GATT once it chooses to become a party to the GATT.

As was expected, there was strong opposition to the Havana Charter in the U.S. Senate. The general impression in the U.S.A. was that it had imposed heavy burden on the U.S.A. to salvage the Europe from economic crisis. Meanwhile, the control of the U.S. Congress passed from the hands of Democrats to Republicans while the Presidency was still with Democratic Party. Sensing the defeat in the Senate, the President in 1950 withdrew the bill containing Havana Charter. And with that, the post-War deliberations to establish a new economic order came to an end.

ECONOMIC THEORIES

As Prof. McDougal put it, social theories have the unfortunate habit of travelling in the pairs of opposites. Free trade and protectionism have always been there in international commercial relations; and they manifested under different garbs. At a given point of time, one theory may appear to be dominant; but its opposite has been waiting in the wings to take the central stage.

The idea of modern state system within a defined territory came into existence in 1644 with the conclusion of the Treaty of Westphalia. Many social theories came up around that time mainly with a view to strengthening the nascent state system. The basic idea was to strengthen the Central authority against centers of power based on feudalism or religion. Mercantilism as a theory on international trade was developed for this purpose. Along with the corresponding political theory of power politics, it held that the acquisition of power, i.e. economic power, in this context, is *summum bonum* of a state. In the absence of modern banking and currency system, economic power meant acquisition of precious metals – mainly gold. To acquire gold from other states, a state should achieve export surplus vis-à-vis other states. It could also simply cutting down imports from other states so as to curtail thy outflow of precious metals which served as money: nationally and internationally. In brief, protectionism under the garb of strengthening the central authority, became the dominant ideology.

The limitation of this theory was obvious: aggressive pursuit of export surplus is a zero sum game, which would soon lead to the shrinking of international trade. However, in the context of power politics, such an aggressive pursuit was considered legitimate.

With the dawn of industrial revolution in 18^{th} century, mainly in the U.K., a more enlightened trade theory emphasizing the expansion of trade was required, because the industrialized countries required to export their industrial products and to import raw materials. Adam Smith, in his Wealth of Nations, published in 1776, met that need. In consonance with the emerging republican spirit emphasizing individual liberty, he argued that a nation's strength should be judged by the wellbeing of the people rather than possession of precious metals. It meant that people engaged in agricultural must not be squeezed to promote industries. Further, Adam Smith believed that division of labor and consequent emphasis upon specialization would contribute to general prosperity. He explained the rationale for free trade as follows:

> *It is the maxim of every prudent master of a family never to attempt to make at home what it will cost him more to make than to buy. The tailor does not attempt to make his own shoes, but buys them from shoe-maker. The shoe-maker does not attempt to make his own clothes, but employs a tailor. ---- All of them find it for their interest to employ their whole industry in a way in which they have some advantage over their neighbors and to purchase with a part of their produce whatever they have occasion for.*
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> *What is prudence in the conduct of every private family can scarce be folly in that of great kingdom. If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry, employed in a way in which we have some advantage.*

In brief, Adam Smith proceeded on the assumption that just like an individual having some advantage over other individuals in respect of skills, a state has also advantage over other states. Hence his exposition is known as the doctrine of Absolute Advantage. But with the advancement of technology, every state can produce almost everything it requires; and a technologically advanced state can have absolute advantage over other states. In this context, David Ricardo advanced the doctrine of Comparative Advantages as a corrective to Adam Smith's doctrine of Absolute Advantage. According to him, even if country A has absolute advantage over country B in production of many goods, it is better for country A to concentrate on producing those goods in which it has relative advantage compared to the production of other goods. To quote his classic example:

> Suppose in England a gallon of wine costs 120 and a yard of cloth 100 unites of work, while in Portugal, a gallon of wine costs 80 units of work and a yard of cloth costs 90 units. Portugal has absolute advantage in both wine and cloth; but England has comparative advantage, since the production of a yard of cloth in England involves in giving up production of 5/6 (100/120) of a gallon of wine, whereas the production of a yard of cloth in Portugal involves giving up 1 1/8 (90 /80) of a gallon of wine. Assuming constant costs, prices accurately reflect costs and ignoring transport and handling, a piece of cloth anywhere between 5/6 and 1 1/8 of the price of wine would make it profitable for Portugal to import cloth and export wine and for England to export cloth and import wine. If the same amount of resources, as before trade, are committed, the output for the two countries will be both more wine and more cloth.

According to Paul Samuelson, if there is one economic theory which has withstood the test of time, it is Daniel Ricardo's theory of comparative advantages, because it has clearly demonstrated how mutually profitable division of labor enhances national production for all nations.

In the recent time, Heckscher and Ohlin developed Ricardo's ideas further by substituting capital and labor. According to them, international trade is determined by fact or endowments and factor intensities.

Even as Adam Smith's theory was gaining acceptance, there was counter attack from Europe. Protectionism in the sense of state intervention to protect community's interest emerged under a new garb: infant industry protection. Friedrich List, a German economist, in his book "National System of Political Economy" argued that free trade would be harmful to countries like Germany which were inferior to England, at that point of time, in industrialization. Free trade for Germany would mean that, it would be flooded with cheap English products; and Germany would never be able to develop its potential. Hence he argued for the protection of nascent industries in Germany through high tariff walls. Around the same time, in the U.S.A., Hamilton, one of the prominent authors of Federalist Papers, argued for encouraging manufacturing in the U.S.A through protectionist policies: and thereby openly repudiating Adam Smith's ideas.

DEVELOPING COUNTRIES AND FREE TRADE

Between 1950 and 1960, large number of developing countries, freed from colonial bondage, emerged on international scene. Most of them have become members of the U.N.O. and other international economic agencies. India was the original member of most of these institutions. But when it came to economic policies, most of them were out of tune with the economic philosophy of these economic institutions, i.e. free trade. The doctrine of comparative advantages meant in this context, the perpetuation of status quo. During colonial period, they mainly served as the suppliers of raw materials to the industries of their colonial masters. A static interpretation of comparative advantages meant that they would continue to be agricultural economies supplying raw materials to the Western world. According to the poignant expression, popularized by Gunnar Myrdal, they will continue to be "hewers of wood and drawers of water" for developed world.

The dilemma faced by developing countries is best expressed by Dr. V. Kurien, the father of India's White Revolution, as follows:

> *They (World Bank economists) talk about comparative advantage, as though it were a prescription, not a description. If comparative advantage was a permanent condition, I suspect that our potatoes would still come from Peru or Ireland; and coal would still be mined in New Castle. The fact of the matter is that comparative advantage can be earned by supporting initiative, energy and investment of our farmers.*

If the doctrine of comparative advantages is to be used as a prescription, as Dr.Kurien put it, the potential of the economy must be taken note of and encouraged. If it does not move beyond the description of existing situation, while prescribing policy initiatives, it would mean perpetuation of the status quo. The problem is how to assess the economic potential of a country. Thanks to modern technology, anything can be produced anywhere; and the human capability to wield technology seems to be the decisive factor. We have countries like Japan with very little raw material base emerging as great economic powers.

There were two kinds of reactions against market fundamentalism advocated by Western countries and international economic institutions. Most of the Communist countries chose to remain outside these institutions. Quite a few developing countries like India chose to the part of these institutions, hoping to change their orientations. They rallied around a charismatic Argentinian economist, Raul Prebisch who served as the Secretary-General of UNCTAD. Raul Prebisch, along with British economist, Hans Singer, after analyzing the data between 1870 and 1930, demonstrated that the terms of trade between primary commodities and manufactured goods have been deteriorating. In other words, year after year, more and more primary commodities had to be sold to acquire the same quantity of manufactured product. To get over this problem, Prebisch argued for industrialization of economies of developing countries through import substitution. He urged the developed countries to dilute the reciprocity consideration while dealing with developing countries. In concrete terms, he argued for preferential treatment to the goods from developing countries in the markets of developed countries. Thanks to his efforts through UNCTAD, the generalized scheme of preferences was adopted within the framework of the GATT. Part IV titled as Trade and Development was added to the GATT by way of amendment in 1966. Many international commodity agreements were concluded to stabilize the prices of primary commodities.

The report submitted by Raul Prebisch to the UNCTAD – II titled as "Towards a New Trade Policy for Development" provided blueprint for the trade policies of developing countries. In this report he makes a strong case for import substitution. Because of the slow growth in demand for primary commodities, developing countries will not be able to expand their import of manufactured products. In so far as they industrialize this economy, they would be better customers for industrial products. To quote Raul Prebisch:

> *Why has the GATT not been efficacious for the developing countries as for the industrial countries? First, the Havana Charter is based on the classic concept of free play of international economic forces by itself leading to the optimum expansion of trade and the most efficient utilization of the World's productive resources; rules and principles are therefore established to guarantee this play. (P. 21)*

In brief, Prebisch advocated strategies combining free trade with protectionism. Protective elements such as preferences, commodity agreements, etc., were devised, keeping in mind unequal position and vulnerability of developing countries.

STRATEGIC TRADE POLICY

The most successful economies of the second half of 20th century were South-East Asian economies including Japan. They are considered as market economies under the WTO categorization. But they are different from classical liberal economies wherein the government and markets are supposed to function at arms' length from each other. In South Korea, the Government has nurtured the leading private companies known as chaebols. In Japan, the Government and industries are so close that they are referred to as Japan incorporated. They are different from communist economies in two significant ways: (a) they are democracies and (b) they are actively engaged in international trade and market signals. In the WTO panel's report on Japan : Measures affecting consumer Photographic film and paper, 1998, we get a glimpse of how the Ministry of Trade and Industries in Japan interacts with the producers and the traders so as to promote efficiency. As the case shows, these policies are designed in such a way as to escape from the clutches of WTO provision.

The strategic trade policy would lead to "managed trade" instead of free trade. Strictly speaking, free trade in the real sense of the term did not exist at any point of time. Negotiations for tariff concessions imply that states have been using tariff for protectionist purposes. In a free trade world, tariff should be minimal, i.e. no more than fees for the services rendered at the border. In such a World, there is no need for elaborate agreements. The very fact that trade negotiations last for years together and the negotiation for TTIP, TPPA etc., have been going on and on, often generating controversies in the countries concerned show that participating countries want to manage the international trade in their respective national interests which often clash with one another.

Modern system of transnationalized production has further complicated the system. Mono-location of production envisaged in the GATT no longer exists. The typical example given in this connection is ipods, manufactured by Apple company of the U.S.A. The invention and the designs are done in the U.S.A by Apple company. But the components including soft wares are sourced from different placed and they are finally assembled in China by Chinese workers under the control of Chinese subsidiary of Apple company. Though it is labeled as "Made in China", the Chinese share would be a very small part of the market price. It was estimated that out of $ 194 paid for an ipod, $ 80 went to the U.S.A and only $ 4 went to Chinese. The rest were distributed among the suppliers of components. Many a time, a product passes through different countries where there would be value additions. The whole process is known as supply chains. Supply chains refer to international network of production in which goods are sent from country to country for value addition, mainly to take advantage low-wage labor and other services. To refer to this multi-location of production, the WTO has coined the expression "Made in the World".

The concept of managed trade and supply chain are in a way intertwined with each other. There are theories that the moves towards regional agreements such as TPPA (i.e. Trans Pacific Partnership Agreement) are guided by supply chain considerations. To operate these supply chains smoothly, the countries involved must have strong IPR protection and efficient customs administration, etc. Trade Facilitation Agreement, projected by developed countries as great achievement, would make the movements through supply chains much smoother. Thus, theses classic interactions between the government and multinational corporations indicate Strategic Trade Policies pursued mainly in developed countries.

CONCLUSIONS:

In abstract, free trade and protectionism represent two ends of spectrum. In practice, no state is likely to identify itself with the extreme ends of the spectrum. States have by and large pursued the policies containing the elements of both: free trade and protectionism. With the establishment of the GATT and the WTO at a later stage, free trade components have become more pronounced in the state policies. The success of East Asian economies is the vindication of their dexterity in conceiving and executing the combinations of free trade and protectionism.

Though the original GATT was very much market-oriented, the presence of large number of developing countries diluted this market orientation to some extent. Article XVIII and Part IV of the GATT recognize the special and differential positions of developing countries. But how far have they helped the developing countries remains a moot question. The demand for more meaningful special and differential treatment still continues. Doha Round of 2001 was especially dedicated to discuss the developmental issues. But even after a decade, nothing significant has come out of it.

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