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THE CONCEPT OF "GRADUATION" OF DEVELOPING COUNTRIES: its genesis in multilateral organizations, a priori criticisms and an estimate of the costs of its application in the case of Brazil*

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The concept of "graduation" of developing countries: its genesis, criticisms and estimated costs of its application in the case of Brazil

Marcelo de Paiva Abreu e Winston Fritsch*

I. Introduction**

In what follows "graduation" refers to the withdrawal of the special, differentiated and more favourable treatment a developing country is entitled to enjoy according to the rules of certain multilateral organizations by reason of its relatively lower level of economic development. Althouth the concept of graduation has recently emerged in discussions on almost every aspect of development assistance policy, this paper focus upon its application in the context of official development finance by the World Bank and of the rules governing multilateral trade relations under the General Agreement on Tariffs and Trade (GATT)***.

In the two above mentioned contexts the consequences of graduation to a given developing country can be defined with greater precision.

In the sphere of development finance, graduation involves the loss of access to loans advanced by multilateral development banks, whose terms - interest rate, repayment and grace periods - are more

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*** Other areas of importance where the concept has at least tentatively been applied are technical cooperation which is dealt with in section VI below and export credits on which there is no reliable information.

favourable than those often obtained by the developing borrower in private financial markets.

As applied to the rules governing North-South trade relations, graduation means either the withdrawal of all rights to differentiated and preferential treatment granted to all developing countries under the GATT, or the elimination - for certain of its export products - of tariff preferences enjoyed by them under the GATT-sponsored Generalised System of Preferences (GSP), by an unilateral decision of the preference-giving industrial country.

This paper in divided into six sections besides this introduction. Section II recalls the forms of special and more favourable treatment granted to developing countries in the context of post-war multilateral organizations. In Section III, the rise of the concept of graduation and its rationale are discussed. Section IV reviews how graduation criteria have been applied in practice. Section V presents the basic a priori criticisms levelled against graduation. In Section VI the costs of graduation to a developing country are quantified taking Brazil as a case study. It is also argued that, especially under the difficult balance of payments position now experienced by a large number of semi-industrialized developing countries, the adoption of graduation policies is not in the interests of the major industrial countries. Finally, the conclusions are summarized in Section VII.

II. The growing awareness of the need for special, differentiated and preferential treatment to developing countries in the framework of post-war multilateral organizations

The growth of a much larger and more differentiated community of nations in post-war years had two important consequences for the framework of international relations. On the one hand, the diminution of the leading industrial countries' ability to manage a stable international order, meant that the definition of the rules of the game in international relations in this new context should contemplate the participation of all nations. On the other hand, the widening differentiation between States made the old concept of juridical equality among parties in international relations increasingly non-operational for the elaboration of the norms of mutual collaboration required by the growing interdependence among nations - especially in the field of economic relations - leading to its substitution by the concept of specificity.

The usefulness of this new concept is that, by recognizing specific differences between States, it allows negotiations and agreements which can produce mutual gains, stimulating cooperation while protecting the interests of the nations involved. Thus, the specifity of economic underdevelopment gave rise to important concessions granted to a large number of developing countries in the form of special, differentiated and more favourable treatment in financial and trade matters in the framework of post-war multilateral organizations.

In the area of finance, preferential treatment to developing countries was prompted by the crucial role played by

official financing to those countries since early in the post-war period as, for a long period after the war, the disorganization of international financial markets restricted borrowing by developing countries to official sources and suppliers' credits.

During this period, the diagnosis of the causes of underdevelopment centered on the lack of capital and foreign exchange and also stressed the importance of an adequate supply of skills. A real transfer of resources was thought at first to be crucial to evade the basic constraint face by developing countries and to overcome underdevelopment: domestic savings were thought to be inadequate to fund those projects essential to maintain growth at a minimum rate.

It came afterwards to be recognized that, in certain situations, the aggregate level of savings was not the actual constraint and that it was important to consider whether the supply of imported goods and services was adequate as "in cases of acute shortage of imported goods, the economy will be unable to transform potential savings into investment because of insufficient supplies of investment goods"*. Access to capital sources at a cost consistent with repayment capacity in the long run was consequently considered to be vital to overcome underdevelopment. Why was the economic development of developing countries thought to be important in the developed world? Political considerations, which had been

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* See A.B. Chenery and A.M. Strout, Foreign Assistance and Economic Development, The American Economic Review, September 1966, for a classic statement of the "two-gap" model.

paramount in the initial post-war US aid to Europe through the Marshall Plan, never lost importance but were importantly complemented by self-interest in the realm of business as faster growth in the developing countries meant rapidly expanding markets for developed countries' exports and direct investment.

Much of this official financing was of a concessionary nature, entailing either low interest rates and very long repayment periods or straignt grants. Besides developed countries' national agencies - such as the U.S. Eximbank and AID - multilateral institutions, of which the World Bank was by far the most important, played a significant role in financing the current account deficits of developing countries.

With the "normalization" of the private financial markets in the late 1960s and the striking development of the Eurocurrency markets it was possible again for many developed countries to borrow significantly from private sources.Consequently, overseas development cooperation came to be much more important - as a proportion of total financial requirements - for the poorer developing countries which faced more difficulties in borrowing from private sources. But development bank credits especially from the World Bank remain an important source of loans for those relatively less poor developing countries which are able to present the best projects and are financially sounder than the very poor countries.

In the sphere of international economic relations, technical cooperation, bilateral as well as multilateral, has been used for more than two decades alongside - and often as a complement to - development financing and the concession of trade preference. This cooperation - at first of a markedly assistential nature - may at times have been motivated by considerations of charity. Later, however, the perspective changed to one of mutual interest, implying the recognition that economic, social, cultural and technological development - and the reduction of disparities in development levels - represented essential postulates embodied in the UN Charter, as well as priorities defined in a regional context.

Once this was recognized technical cooperation had to focus above all on

obligations governing multilateral trade relations within the framework of the GATT took long to materialize.

In a formal sense this was a consequence of the need to preserve the basic principle of non-discrimination embodied in Article I of the GATT: the clause of Most-Favoured-Nation (MFN) treatment, according to which tariff concessions negotiated between two contracting parties should be automatically and unconditionally extended to all other parties. This liberal tenet was the basic principle upon which the GATT's legal structure was erected and which, together with the principle of Reciprocity - which implies that gains accruing to negotiating parties in multilateral trade negotiations should be in some sense equivalent - was expected to assure the effectiveness of the GATT as a trade-liberalization device.* Its paramout importance to the GATT, it was argued, ruled out the possibility of granting preferential - and, as such, discriminatory - treatment in favour of developing countries.

The first two post-war decades would, however, witness a steady departure from the rigid application of GATT principles by many of their leading parties as well as a growing disbelief in its efficient operation in the sphere of North-South trade.

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* The basic liberalizing drive of trade negotiations under GATT was expected to result from the complementary operation of these two principles. While reciprocity would provide a guiding rule for tariff negotiations among contracting parties, the MFN clause would warrant that bilateral concessions were spread multilaterally.

Firstly, the action of the major European countries would slowly undermine the sanctity of the non-discrimination principle. To counteract the almost absolute U.S. post-war hegemony in world trade negotiations and reap the dynamic growth effects of economic integration, most European countries grouped together in two weighty free-trading blocs - the European Customs Union of the EEC and the European Free Trade Association (EFTA)*. Moreover, old colonial empires reenacted quasi-mercantilist "special" trading subsystems - such as the British Commonwealth Preference Area and the French Union - or created closed preferential trading areas as in the Yaoundé Convention,** in a clear breach of the MFN clause.

Secondly, in spite of the impressive results achieved in the successive multilateral trade negotiations (MTNs) until the mid-sixties,***, it became increasingly clear that, given the uneven distribution of trading power and the existing differences in the industrial structures of developed and underdeveloped GATT members, the operation of its liberal and formally equitable rules were provoking great distortions in the distribution of the benefits of trade liberalization.

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* Note that the formation of a free-trade zone, by eliminating tariff barriers on intra-bloc trade, places exporters outside the zone at a disadvantage relatively to suppliers within the zone, violating the non-discrimination principle.

** The Convention was an outgrow of an agreement of the EEC of six under the Treaty of Rome to establish closer economic ties with eighteen African countries with which Belgium, France, Italy and the Netherlands had special neo-colonial ties. The first preferential trade agreement was signed in 1963.

*** There were six MTNs during this period: in Geneva (1947), in Annecy (1949), in Torquay (1951), in Geneva (1956), and the so-called Dillon (1960-61) and Kennedy (1963-67) Rounds in Geneva. As a result, average tariff levels for a group of eight OECD countries (the United States, Japan, Germany, France, the United Kingdom, the Netherlands, Belgium and Sweden) fell from about 50% in 1950 to slightly over 25% by the end of the fifties, to 18% after the Dillon Round and to 9% after the Kennedy Round.

The immediate causes of those distortions were twofold. On the one hand, they stemmed from the very application of the reciprocity principle as the cornerstone of the negotiating process in MTNs under the GATT framework. In fact, although explicit criteria for gauging the value of tariff concessions were lacking in the GATT, the traditional approach has been to measure them as equivalent to import volumes in a given year multiplied by the tariff rate changes granted on those products.* This practice implied that in the "reciprocal bargaining" process established at MTNs, the substantive concessions covering industrial products were bilaterally negotiated among the leading industrial nations or trading blocs, usually the relevant suppliers of products on which concessions were being offered. On the other hand, such distortions also resulted from the developed countries' failure to comply with the GATT's liberal principles by imposing absolute non-tariff barriers whenever compliance with those principles would entail implementing politically costly or undesirable domestic structural adjustment policies. These protectionist practices were widespread in connection to competitive agricultural products and "import sensitive" industrial products - usually the output of labour-intensive or technologically backward industries and both products of great interest for the trade of developing countries. The natural outcome of these distortions in trade negotiations under the GATT was that the structure of protection in industrial countries became incresgingly biased against developing countries' exports.

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* On this, see, for instance, S. Weintraub, Trade Preferences for Less-Developed Countries: An Analysis of U.S. Policy, New York, pp. 4-5.

Although the GATT's failure to positively respond to the trade needs of underdeveloped countries was identified as early as the late 'fifties * and such problems formally placed in the GATT agenda in the early 'sixties , no significant practical changes ensued. The only noticeable change was the rather formal recognition of the possibility of special treatment for developing countries under a new Part IV(Trade and Development) of the GATT, inserted in 1965, including a so-called relative reciprocity principle (Article XXXVI, §8) whereby developing countries were allowed to benefit from tariff concessions negotiated by other parties even without making concessions of their own. This, of course, could hardly be considered as an actual non-reciprocity clause since the fact that any additional developing countries' export earnings resulting from industrial country tariff concessions would be entirely spent on imports from the latter means that developing countries fully reciprocated those concessions even if their tariff structures remained unchanged**.

However, the debate on the trade problems of the Third World in the first half of the 'sixties were not confined to the GATT. Indeed, after the U.N. General Assembly's 1961 resolution to call a conference on international trade and development, the growing LDC desillusionment with the GATT's effectiveness slowly undermined its position as a forum for the discussion of North-South trade relations. Not surprisingly, when the first United Nations Conference on Trade and Development (UNCTAD) was held in 1964, the problem of

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* See GATT (The Haberler Report), Trends in International Trade: a Report by a Group of Experts, Geneva, 1958.

** For an elaboration of this argument, see H.G. Johnson, Economic Policies Towards Less Developed Countries, London, 1967.

trade preferences - among many others outside the scope of this study* - reemerged in the shape of demands for a Generalized System of Preferences (GSP) to be extended by the industrial countries to all developing countries.

The advantages developing countries could derive from the GSP were twofold. Its immediate impact would be felt on the export earnings of a beneficiary country through the operation of static price advantages - caused by the tariff cut on its export products - increasing their competitiveness in the preference-giving country markets vis à vis domestic production and imports from third countries. By helping to overcome the limitations imposed on industrialization by the size of domestic markets in developing countries, their increased access to developed country markets was also expected to bring important dynamic advantages through the stimulus to faster productivity growth in the beneficiary countries. Although these long-run advantages are difficult to quantify, they provided an important argument for the concession of tariff preferences to developing countries.

The widely divergent interests of the three basic groups of countries represented at UNCTAD - the developing countries now represented by the Group of 77, the socialist and the OECD countries - on the question of trade preferences ** produced at first a very inconclusive debate on the issue. The OECD countries, however, did not present an united

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* On this see UNCTAD (The Prebisch Report), Towards a New Trade Policy for Development, Report by the Secretary-General to the UNCTAD, New York, 1964.

** "The developing countries desired increased access to OECD-country markets. The socialist countries wished goodwill from the developed countries and a chance to highlight the evils of the developed countries of the West. The OECD countries played a defensive game attempting to safeguard the status quo while appearing to be sympathetic to the trade and development problems facing the developing countries". T. Murray, Trade Preferences for Developing Countries, New York, 1977, p. 14.

front. The United States, which had traditionally been in the forefront of the opposition to the concession of tariff preferences on the grounds that this would not justify a formal breach of GATT's non-discrimination principle, reinforced its traditional argument by adding that with the low OECD tariff levels to be achieved after the Kennedy Round, the gains from preferential treatment would be small. The real motives underlying the U.S. traditional negotiating position were, however, that a formal breach of the MFN clause would open the door for trade regionalization along bilaterally negotiated preferential lines, a trend which had the support of some European countries which envisaged to use the concession of tariff preference to former colonies to promote their own national objectives and was clearly detrimental to U.S. economic and political interests*. Thus, when to increasing developing countries' pressure was added the growing threat of proliferation of regional preferential agreements on the lines of the "Mediterranean policy" of the EEC or the recently signed Yaoundé Convention, the Americans rapidly evolved towards accepting the GSP as a defensive stance.

U.S. adherence to the GSP idea - the removal of the major stumbling block to the progress of the talks on trade preferences - was announced in April 1967 and following that the pace of negotiations quickened. After unanimous agreement on the establishment of a GSP was reached at UNCTAD's 1968 New Delhi meeting, the OECD countries submitted their preference offers, and the required reform of Article I of the GATT took place in the form of a 10-year

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* T. Murray, op.cit., pp. 14-7.

waiver of the MFN clause in June, 1971. In the next five years the various GSP schemes were established: by the EEC, Japan and Norway already in 1971; by Austria, Denmark, Finland, New Zealand, Sweden, Switzerland and the United Kingdom in 1972*; by Canada in 1974 and, finally, by the United States in 1976.

III. The Evolution of the Concept of Graduation

It was within the World Bank that the principle of graduation has first been discussed, defined and somewhat vaguely implemented. However, in spite of assertions to the contrary, graduation was not an established "principle" in the World Bank until the early 1970s and is not even now very clearly defined or very firmly established as will be seen below.

The roots of the principle can be traced to an explicit decision in the early 1960s that the International Development Association (IDA) credits (50 year maturity, 10 year grace, 0.75% service charge, no interest rate) should benefit only the poorest developing countries (now the criterion involves the exclusion of countries with GNP per head higher than US$730 at 1980 prices)**. It is true, however, that from the start the World Bank concentrated its operations in loans to developing countries, based on the principle that developed countries could borrow elsewhere. This in fact constituted an explicit exclusion policy akin to graduation. From the moment that it was possible for developing countries to borrow in the international private capital

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* When, subsequently, some of these countries joined the EEC, their individual GSP schemes were terminated.

** This "low grade" graduation has been recently termed "maturation". See, for instance, United States Participation in the Multilateral Development Banks in the 1980s, Department of the Treasury, Washington D.C., February 1982.

markets - in contrast with the period before the late 1960s - the Bank started to consider the adoption of an explicit graduation policy at least in principle related in the long run to a reduction in the pressure of demand over its limited funds. But in a book on the World Bank published in 1973 as comprehensive as Mason and Asher* an adequate discussion of graduation in its present meaning is nowhere to be found.

By 1974 an explicit policy had been formulated but the term graduation was still not used: "the bank does not have a rigid definition of what constitutes a developing country, however, some former borrower countries have become strong enough to finance development projects on reasonable terms from their own resources, or from external sources other than the bank. At this stage, the bank will usually make no further loans. But the Bank remains ready to consider a loan whenever a country cannot obtain finance on reasonable terms for a suitable development project from other potential lenders"**. GNP per head was to serve as a rough indication of the ability to substitute private loans for bank borrowing and US$1,000 (1970 prices) was thought to be an adequate threshold to start a review for graduating a specific country***.

The main rationale for the adoption of a graduation policy has been that as financial and staff resources are limited they should be reserved to meet the needs of poorer countries****. The US government in particular has come to the fore in recent years pressing

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* E.S. Mason and Robert E. Ascher, The World Bank since Bretton Woods. The Origins, Policies, Operations and Impact of the International Bank for Reconstruction and Development and the other members of the World Bank Group: the International Finance Corporation, the International Development Association, the International Centre for Settlement of Investment Disputes, Brookings, Washington, 1973.

** Questions and Answers. The World Bank and IDA, January, 1974, p. 9.

*** Graduation from the Bank, IBRD memo, Jan 6, 1982, mimeo, pp. 1-2.

**** Graduation from the Bank, cit. pp.1-2; United States Participation, cit. p.68.

for the rigid adoption of graduation policies by the World Bank in particular and multilateral development banks (MDBs) generally*.

More recently graduation has been defined as "a process of slowly phasing out IBRD lending as a borrowing country reaches a level of development, management capacity, and access to capital markets that permits it to carry on without IBRD financing". In spite of many provisos and qualifications to meet previous criticisms on the lack of flexibility of its policies, the Bank still insisted quite late in the day that graduation was likely to occur within five years after a country reached the GNP per capita of US$2,650 at 1980 prices (equivalent to US$1,000 at 1970 prices)**.

While a wholehearted redefinition of the Bank's policies in the light of changed circumstances in the world economy since the second semester of 1982 has not occurred, the Bank's actual operations in the meantime suggested a softening of its policies as stated in 1982 and in September 1984 there was a partial volte face on previous policy***. Indeed reasons that the IDA in 1974 thought relevant to explain the need for concessionary financing to the poorest developing countries have now become much more serious and widespread: "a number of developing countries already have, or are building up, an intolerable debt burden. These debt service payments are often rising more rapidly than their earnings of foreign exchange from exports. Some countries now devote 20% or more of such earnings to the servicing of their debts"****.

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* United States Participation, cit, p. 79:"the existing IBRD graduation policy should be implemented more effectively and emulated in the regional banks". The adoption of graduation criteria similar to those of the World Bank by the Inter-American Development Bank is not likely due to the smaller leverage afforded in the latter by developed countries' voting shares. Negotiations on US appropriations have, however, resulted in an informal agreement that no large Latin American country will increase its borrowings beyond US$250 million yearly.

**The World Bank Annual Report, 1982, p. 35.

***It must be stressed, however, that Bank's new Statement on Graduation, R84-252, September 6, 1984 does not imply an abandonment of previous policy. Graduation is still considered "a natural outcome" for developing countries; per capita income "may" be used as an indicator; the Bank "may" then initiate consultations with the relevant countries and "may" discontinue lending after a phasing out period. This inflation of "mays" should not to be taken as an assurance that graduation has been abandoned as a policy by the Bank and, indeed, one should expect that provided international conditions improve in the future the problem will recur.

****Questions and Answers, pp. 49-50. Brazil has been recently using up to 70% of her export earnings to pay the foreign debt service.

Since the early seventies, a taxonomy of developing countries based on narrow criteria, primarily per capita GNP (and special conditions such as land-locked or island-country status) has also emerged in institutions responsible for managing multilateral technical cooperation - e.g. the UNDP - as a basis for programme, and even administrative, resource allocations.

In the sphere of North-South trade relations the idea of graduation is no more than an outgrow of the general trend towards greater protectionism in OECD countries since the early seventies, prompted to a large extent by worries about the increasing competitiveness of manufacturing exports from semi-industrialized developing countries*.

Ironically, however, the introduction of the concept of graduation of developing countries in the trade rules of the GATT took place during the last MTNs - the first to be held since the introduction of the GSP - launched in 1973 by the Tokyo Ministerial Declaration** which had as one of its two prominent objectives to bring "additional benefits for the international trade of the developing countries so as to achieve a substantial increase in their foreign exchange earnings, the diversification of their exports, the acceleration of the growth of their trade... and a better balance between developing and developed countries in the sharing of the advantages resulting from this expansion..."***.

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* A detailed analysis of the recent rise of protectionism in industrial countries and of the causes and the problems posed to them by growing LDC participation in trade in manufactures is beyond the scope of this study. For a general appraisal of these phenomena see UNCTAD, Protectionism, trade relations and structural adjustment, Item 10 - Policy paper, Belgrade, June 1983; OECD, The Impact of the Newly Industrializing Countries on Production and Trade in Manufactures, Report by the Secretary-General, Paris, 1979; and A. Fishlow, J. Carrière and S. Sekiguchi, Trade in Manufactured Products with Developing Countries: Reinforcing North-South Partnership, The Triangle Papers: 21, New York, Tokyo and Paris, 1981.

** The Tokyo Declaration issued after a meeting of foreign ministers in Tokyo on September 1973 formally launched the so-called Tokyo Round of MTNs, whose active phase of negotiations began in February 1975 and was formally concluded by the issuing of the Procès-Verbal of April 12, 1979, adopted in Geneva.

*** Tokyo Declaration, September 12-14, 1973, para 2, quoted in R. Kemper, The Tokyo Round: Results and Implications for Developing Countries, World Bank Staff Working Papers nº 372, Feb. 1980, p.1.

Developed country willingness to pursue these stated objectives during the MTNs was undoubtedly undermined by the rise of protectionist pressures due to the damaging impact of the first oil shock on their levels of investment and employment. However, their insistence upon the acceptance of the principle of graduation at the Tokyo Round can only be properly understood as a defensive reaction to the unprecedented pressures then put by developing countries to fulfill their long-standing demands for fundamental reforms in GATT rules. From the very outset of the negotiations, the LDCs - which were for the first time massively represented at GATT talks* - pressed for the creation of a proper forum for discussions aimed at implementing the "improvements in the international framework for the conduct of world trade which might be desirable in the light of progress in the negotiations..."**, as proposed in paragraph 9 of the Tokyo Declaration***. As a result, by the end of 1976, a special committee known as the Framework Group was created to work out the improvements to be made in the rules governing trade between developed and developing countries - with special reference to differential and more favourable treatment - so as to bring them closer into line with the trade and development needs of the latter.

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* Ninety-nine countries, accounting for 90 per-cent of world exports-of which only twenty six were contracting parties to the GATT - participated in the Tokyo Round, against forty eight countries in the previous Kennedy Round. R. Kemper, op.cit., p.1.

** GATT, Agreements Relating to the Framework for the Conduct of International Trade, Geneva, 1979, p.3.

*** For a general review of the negotiations concerning the issues of special relevance to developing countries in the Tokyo Round see T.E. Ibrahim, Developing Countries and the Tokyo Round, in Journal of World Trade Law, vol.12, Jan/Feb 1978; B. Balassa, The Tokyo Round and the Developing Countries, in Journal of World Trade Law, vol. 13, March/April 1980; UNCTAD, Multilateral Trade Negotiations: Evaluation and Further Recommendations Arising Therefrom, Manila, 7 May 1979; and R. Kemper, op.cit.

The developing countries' major negotiating objective within the Group was to enlarge and make legally binding the rights to special and more favourable treatment achieved since the 'sixties . Of special importance in this connection were the improvements to be made in the GSP. Besides a general desire to increase its effectiveness* there was the specific intention to make perpetual and to place on a permanent legal basis the concessions granted under the GSP which, should be recalled, were accepted at the GATT as a 10-year waiver of the non-discrimination principle. Last but not least, there was the intention to make more binding on industrial countries the somewhat loose commitments made under the relative reciprocity principle incorporated in 1965 in Part IV of the GATT**, as well as to extend the application of differential and more favourable treatment to all other GATT provisions concerning non-tariff measures, whose importance was to be greatly augmented as a result of ongoing discussions in the MTNs.

On the other hand, it was clear from the beginning of the negotiations that the industrial countries would not agree with the extension and legal formalization of differential treatment for LDCs within the GATT without a simultaneous commitment to "graduate" the beneficiaries of such treatment as long as improvement in their development and trade situation so permited. In fact, with the benefit of hindsight it can be said that their main objective was to guarantee

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* The main complaint in this connection was that a host of protectionist measures hindered the extension of preferential treatment to a large number of goods of great interest to LDCs in the actual implementation of the individual GSPs. In fact, in 1980 the GSP covered only 48.8 percent of total dutiable (non duty-free) OECD imports from developing beneficiary countries, whereas only 21.3 percent of these were in fact enjoying preferential tariff treatment. See UNCTAD, Protectionism, Trade Relations etc., cit. p.7., and Section IV below.

**This principle stated that developing countries "shall not be expected", in the course of MTNs, to make concessions" inconsistent with their individual development, financial and trade needs".

that the introduction of a legal framework to perpetuate non-reciprocal concessions would not prevent the possibility of excluding product-country pairs from the benefit of individual GSPs if necessary on protectionist grounds, as had been the practice in the main GSP schemes.

The results of the Framework Group efforts, as embodied in the final GATT Decision on "Differential and More Favourable Treatment, Reciprocity and Fuller Participation of Developing Countries" of November 28, 1979 - also known as the "Enabling Clause" - reflected, not unexpectedly, a compromise between those divergent interests.

Developing countries attained many of their objectives as, for instance, (i) the formal possibility of discriminatory concessions to developing countries*, (ii) the explicit revokation of the non-discrimination principle in relation to preferential tariff treatment under the GSP as well as to differential and more favourable treatment with respect to provisions concerning non-tariff measures,** and (iii) to sharpen the wording of the relative reciprocity clause of Part IV***.

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* Paragraph 1 of the Decision reads: "Notwithstanding the provisions of Article I of the General Agreement, contracting parties may accord differential and more favourable treatment to developing countries, without according such treatment to other contracting parties". Idem, p.5.

** Idem, p.5. These provisions are part of Paragraph 2 of the Decision.

*** This clause, now Paragraph 5 of the Framework Group Decision, reads: "The developed countries do not expect reciprocity for commitments made by them in trade negotiations to reduce or remove tariffs and other barries to trade of developing countries, i.e., the developed countries do not expect the developing countries, in the course of trade negotiations, to make contributions which are inconsistent with their individual development, financial and trade needs. Developed contracting parties shall therefore not seek, neither shall less-developed contracting parties be required to make, concessions that are inconsistent with the latter's development, financial and trade needs", Idem, p.6. Emphasis added.

However, industrial countries also achieved their defensive goal with the incorporation of a "graduation clause" in Paragraph 7 of the Decisions, according to which: "Less developed contracting parties expect that their capacity to make contributions or negotiated concessions or to take other mutually agreed action under the provisions and procedures of the General Agreement would improve with the progressive development of their economies and improvement in their trade situation and they would accordingly expect to participate more fully in the framework of rights and obligations under the General Agreement". Although drafted in very general and non-operational terms, the clause certainly implied that less-developed-country status enjoyed by a contracting party to the GATT - and the ensuing differentiated and more favourable treatment enjoyed under the General Agreement - could be reviewed in the light of "the progressive development of their economies and improvement in their trade situation".

Not surprisingly, developing countries reacted strongly to the graduation clause* and, indeed, it is not difficult to demonstrate the weakness of the arguments put forward by the industrial countries to justify it in principle.

The clause was justified on two basic grounds: equity in the distribution of developed countries' non-reciprocal concessions among developing countries, and the preservation of basic liberal principles in the rules of the GATT.

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* The Group of 77 considered it as "an unilateral and arbitrary manner of discrimination among developing countries". UNCTAD V, Declaration of the Group of 77 on the Multilateral Trade Negotiations, Part II, no. 5, Manila.

It was argued that graduation is equitable because it guarantees that the benefits accruing from the GSP are increasingly concentrated in the more needy, "least-developed" countries among the LDCs. This argument has the strenght of shifting the discussion of trade preferences to the framework of industrial country development assistance policy where the concept - as applied in the sphere of financial assistance - could claim at least a longer existence. However, although even academics have questioned whether the "limited political tolerance to the instrument [of trade preferences] should be exhausted by its further liberalization if the primary beneficiaries of that liberalization will be relatively prosperous LDCs"*, it can be shown that this is a speculation without a trace of empirical evidence. In fact, as would be expected a priori given the concentration of GSP preferences on manufactured products, the lion's share of the gains from the contraction of exports of the larger, semi-industrialized, GSP beneficiaries caused by the withdrawal of tariff preferences would accrue to the GSP-donor country domestic producers and its other OECD suppliers. This has been recently admitted even by public officials of the highest authority in the leading industrial

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* W. Cline, N. Kawanabe, T.O.M. Krousjö and T. Williams; Trade Negotiations in the Tokyo Round: a quantitative assessment, The Brookings Institution, Washington, 1978, p.222. The authors go on to say that, instead, "the ideal policy probably would be to grant unrestricted preferential access only to a list of 'poorest' LDCs, such as those eligible for IDA lending". Idem.

countries*.

It was argued that graduation is a guarantee of progressive trade liberalization in the GATT system because it prevents the consolidation of a two-tier system of world trade in which developing countries would have little incentive to contribute towards freer trade**. Although these arguments are, in principle, undeniably correct, they are also an admirable instance of the use of liberal rethoric when it suits the interests of parties involved in trade negotiations. In practice one can hardly say that trade preferences for developing countries constitute an effective barrier to further liberalization of the multilateral trading system while other and infinitely greater distortions, such as the widespread barriers to trade in agricultural

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* Compare the following statement by Ambassador W. Brock, U.S. Trade Representative, in a recent U.S. Senate Hearing on the renewal of the American GSP:
"Senator CHAFEE: Well, I'm down at a much more fundamental level... And the thing that bothers me - I'm in for the GSP program and supportive of it, and think it's splendid that we are doing it for those countries that are truly entitled to it, but when you read that the top five countries gobble up 63 percent of the advantages under this program you just wonder how much of it is getting out to the LLDCs that we are truly worried about.
Ambassador BROCK: I understand that... the 5 or 10 countries that are the most competitive are going to receive the overwhelming bulk of the benefit. But I pose it to you in a different way Senator. What if we removed the benefit from the top three, four, five, six, whatever number, and simply said they are not allowed to have GSP? I think I can document the fact that all of the benefits they now get would go to Japan and Germany and Great Britain and France and almost none would go to the least developed that I think you are concerned with".
U.S. Senate, Committee on Finance (Subcommittee in International Trade), Renewal of the Generalized System of Preferences: Hearing, USGPO, Washington, August 4, 1983, pp.9-10.

** For a defence of this argument see I. Frank, The "Graduation" Issue in Trade Policy Toward LDCs: A Background Study for World Development Report, 1979, World Bank Staff Working Paper no. 334, June 1979. In this connection, a standard argument presented by industrial countries was that perpetuation of the GSP consolidated a vested interest in developing countries against multilaterally negotiated tariff reductions, since the latter evaded the preferential margins enjoyed under the GSP - which, of course, are directly related to the height of the MFN tariff then in force on GSP eligible products

products and manufactures such as textiles and steel - designed to keep developing countries' exports off OECD markets-are in force.

IV. How graduation criteria have been applied in practice?

Even if multilateral organizations defined no formal criteria for graduating a country, some sort of graduation procedures have been applied by the World Bank and in the context of the GSP.

Graduation criteria in the World Bank are applied in a much more haphazard way than the bank's statements on the subject would suggest. The following countries have been graduated in the 1970s: New Zealand (1969), Iceland and Venezuela (1971), Finland and Israel (1972), Ireland (1973), Spain (1974), Singapore (1975) and Greece (1976). These countries have been graduated at GNP per capita levels considerably in excess of the threshold of US$1,000 at 1970 prices were reached (see Table 1). These varied from a minimum - excluding Venezuela - of 33% beyond the graduation threshold in the case of Spain to not less than 153% beyond this level for Finland.It is difficult to explain these differences having recourse only to different outcomes of reviews which, as the Bank states, "examine the country's overall economic situation and its ability to sustain a long-term development program with particular reference to two important factors that influence the pace of graduation:access to capital markets on reasonable terms and the extent of progress in establishing key institutions for economic and social development...".* Perhaps after all politics plays a role in the

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* The World Bank Annual Report, 1982, p.35.

World Bank's decision-making process.

If Brazil's GNP per capita in 1984 is taken to be about US$2,000 at 1980 prices - which may be a substantial overestimation especially if the recent cruzeiro real devaluation is taken into account - and supposing a real increase in GNP per capita of 3% a year* - which may turn out to be optimistic in face of the prospects for the Brazilian economy in the rest of the century - the graduation threshold is not to be reached before 1995. If the bank proved to be as accommodating in the case of Brazil as in the case of Spain, the graduation date, supposing that GNP per capita expands at the constant

TABLE 1

GNP per capita at graduation time

COUNTRY	GRADUATION DATE	GRADUATION GNP PER CAPITA US$ (1970 prices)
New Zealand	1969	2,350
Iceland	1971	2,340
Venezuela	1971	1,000
Finland	1972	2,530
Israel	1972	2,350
Ireland	1973	1,600
Spain	1974	1,330
Singapore	1975	1,500
Greece	1976	1,460

Source: computed from annex 1, Graduation from the Bank memo, Jan 6, 1982.

* This implies GNP yearly growth at a rate slightly over 5%.

yearly rate of 3%, will be postponed until 2005; if the Finnish case is taken as representative Brazil would graduate ceteris paribus around 2026.

Developed countries and international organizations such as the World Bank have been resisting to the discussion of more flexible criteria for graduation such as adopting a crawling threshold equivalent to a specified proportion of the average GNP per head level of developed countries (US$10,320 at 1980 prices). A 1979 internal proposal in the World Bank to abandon the US$1,000 (1970 prices) static threshold established in 1973 in favour of a flexible threshold equivalent to 30% of the average GNP per capita level of developed countries (US$3,100 at 1980 prices) was not considered by the Board. Its adoption would result in an increase of about 17% of the threshold now theoretically in operation but, more important, will increase yearly at the same rate of increase of the GNP per capita of developed countries.

Graduation criteria have also been applied in the realm of technical cooperation. As a result, the overall level of UNDP programmes fell in real terms by approximately 14% from 1972/6 to 1982/6. The resources allocated for cooperation with Latin America (except Haiti) have undergone a substantially larger reduction in real terms: in the case of Brazil, for instance, they remained static in dollar terms at $30 million for the 1982/6 programme cycle, representing a drop of more than 50% in real terms from the first (1972/6) cycle. A further reduction of budget levels to US$3,2 million per annum occurred in 1984 as part of an across-the-board UNDP budget cut. This culminated,despite the periodic reaffirmation of the principle of universality in all UN-system institutions , in suggestions to UNDP and other agencies that in the near future middle-income countries (defined in terms of per capita GNP) should be graduated out of technical cooperation programmes.

Differentiation and even exclusion based on per capita GNP criteria may have a political appeal if technical cooperation is seen as assistance. It is far less plausible, however, if one sees technical cooperation as

a joint effort to overcome development imbalances in the interest of the international community as a whole, and not as assistance motivated by charity. In such a perspective, it can in fact not be ignored that the need and the absortive capacity for multilateral technical cooperation are particularly great in countries which have made substantial progress in terms of income, productivity, economic diversification and competitiveness.

Although no instance of graduation of a less developed party to the GATT is on record and, indeed, a concrete case has never been presented to the organization, the concept is not unheard of in the context of GSP programs.

Graduation, officially defined as "the discretionary removal from the GSP list of beneficiary countries on a product by product basis"* has been systematically applied by the U.S. government, and other major GSP-donor countries seem to be in the process of following this practice.

Defined in this way, however, graduation is just a new justification for further protectionist measures which will greatly erode the benefits developing countries can derive from the operation of the GSP. Indeed, since their inception, the major GSP programs of the U.S., the EEC and Japan - which together account for over 90 percent of the total trade under such schemes - have been plagued by protectionist safeguards. A large number of "mandatory exclusions" were incorporated in individual GSP legislation, excluding a large number of agricultural products and "import sensitive" manufactures from the list of eligible products. Moreover, especially in the case of industrial products, effective eligibility of a particular product-country pair was made conditional to its imports being lower than ceilings defined by the preference-giving country - the so-called "competitive need" limits of the U.S. legislation**. The operation of these constraints by

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* Office of the U.S. Trade Representative, A Guide to the U.S. Generalized Systems of Preferences (GSP), Washington, September 1983, p.5.

** In the case of the U.S. GSP a beneficiary shall loose its eligibility with respect to a product if either of two competitive need limits are excluded: 50 percent of the value of total American imports of the product, or a dollar value, equal to US$53.3 million in 1982 and reviewed annually according to U.S. GDP growth. In the case of the EEC and Japan these ceilings - applicable to all industrial products - vary according to the product and are also periodically reviewed. For a detailed description of these constraints see T.Murray, op.cit., Chapter 5.

limiting the effective eligibility of a large number of products have a considerable effect on the benefits LDCs can derive from the GSPs, as Table 2 shows.

Against the data presented in Table 2 the effects of the further restraints imposed by recent U.S. "graduation" policy can be gauged: in 1981 and 1982 only, its first two years of operation, the over 100 products, from the leading seven beneficiaries which were excluded from the GSP, represented a value of trade of US$1,094 million*, that is, the equivalent of 22 percent of the total trade eligible for preferential treatment in 1980.

TABLE 2

Erosion of GSP benefits by protectionist safeguards: 1980
(in millions of U.S. dollars)

GSP donor and Product Class*	Total Imports	Dutiable Imports	GSP Imports	
			Eligible	Actually Enjoying Preferences
USA				
Agricultural	21 814	9474	3363	1717
Industrial	48 667	44354	10948	5591
EEC				
Agricultural	19 808	8653	3288	1880
Industrial	101 418	29237	23421	7461
JAPAN				
Agricultural	6 237	4635	977	902
Industrial	22 877	7987	7510	4083

* Agricultural and industrial products are defined, respectively, as products belonging to chapters 1-24 and 25-99 of the CCC Nomenclature.

Source: C.R. MacPhee, Evaluation of the Trade Effects of the Generalized System of Preferences, UNCTAD, Special Committee on Preferences, TD/B/C.5/87, Geneva, 19, January 1984.

* See U.S. Senate, Hearings, cit., p.8.

V- A priori criticisms of the graduation concept

The main a priori criticisms levelled against graduation relate either to its unilateral imposition by developed countries reflecting a dangerous tendency to substitute a narrow bilateralist approach for the multilateral framework in which special treatment to developing countries was traditionally considered, or to the arbitrary division affecting specific developing countries resulting from the limitations of applying a single criterion such as GNP per head as a graduation threshold.

Graduation as an unilateral concept

Developed countries are able to impose graduation policies in financial matters basically because they hold voting control in the IBRD. However, this does not make less unilateral their action - in the sense that policies are adopted which do not result from negotiation with all parties concerned - nor less fragile the concept.

Although no formal procedure exists in the rules of the GATT for the outright graduation of a less-developed contracting party, such a decision should, of course, involve collective deliberation. Even the withdrawal of the differentiated and more favourable treatment granted by a contracting party under the Enabling Clause can only be done after consultations involving - if so requested by an interested party - all contracting parties.*

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* See Paragraph 4 of the GATT Decision on Differential and More Favourable Treatment, Reciprocity and Fuller Participation of Developing Countries, cit.

Nevertheless, as described in the preceding section, since 1981 the U.S. has established, and other major GSP-donor countries are in the process of establishing, directives for the "graduation" of product-country pairs from the list of GSP - elligible products. This is done is an entirely unilateral basis on the grounds that the GSP is an unilateral concession, involving no contractual obligation on the part of the preference-giving country. It can be argued, however, that "graduation", thus understood, is just a different label for neo-protectionist "safeguards" agains "market disruption" by "excessively competitive" imports, and one more instance of the erosion of the multilateral trading system by narrow bilateral defensive actions taken by the industrial countries.

While developed countries have stressed that their support of graduating policies is related to broader, global, considerations such as the need to reserve resources for those countries which need them most, it is becoming increasingly clear that such stances both in the commercial and in the financial spheres can be much better explained by self-interest than by equity arguments. American recent policies on MDBs clearly envisage a reduction in US appropriations and it is in this context that graduation is being pressed on the MDBs*: countries are to be graduated to allow the reduction of US involvement in MDBs and not to free resources for those in more need.

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* United States Participation etc, cit., pp. 8-11.

The recent American Trade and Tariff Act provides for the renewal of the U.S.GSP grants powers to the President to lift competitive need limits previously in force in the American scheme at his discretion and allows for the reexamination of the elligibility of all beneficiary countries in two years' time. The obvious objective of these provisions is to transform the concession - or, rather, the threat of withdrawal - of the GSP in an element of bilateral bargaining in trade negotiations with GSP beneficiaries.*

Graduation as an arbitrary concept

Criticisms of the lack of flexibility of the graduation concept or of its lack of symmetry have never been adequately met. Why is there a single threshold? Why an all or nothing procedure and not a gradual one? The crux of the matter is the resistance by countries recently graduated or on the brink of graduation to consider fair that they should be treated as part of a homogeneous group together with the super-rich in the name of a policy based on stressing their heterogeneity in relation to other developing countries. The iniquity of such policies has prompted retaliatory - but not very realistic - suggestions that by symmetry with graduation there should be a super-graduation process to ensure

*As the U.S.Trade Representative stated before a Senate Committee, in reconsidering the graduation of a product-country pair affected by competitive need criteria "the President would consider the various factors required under current statutory and administrative procedures. One of these factors involves the extent to which a beneficiary country has assured the United States of reasonable and equitable access to its markets." Statement by Ambassador W.E.Brock in U.S.Senate Hearings, cit., p. 8.

that the super-rich countries contribute more adequately to the growth of developing countries. But the object of introducing a new taxonomy should be to turn the lending policies of MDBs and the trade policy of the industrial countries more liberal and not simply to be considered as an argument by Northerners to show that the old North-South model is a thing of the past in an effort to undermine the rather close political links of the Group of 77. Indeed, the political unity of the Group since the early 1960s is a consequence of a common view of the shortcomings of the international economic order rather than of its economic homogeneity.

Speculation on the adoption of a less crude criterion underlines the limitations of the taxonomy implied by the use of the graduation model in finance. The world economy is to be divided by the adoption of graduation into developed countries (including the graduated), developing countries (having access to the World Bank's hard window) and low-income developing countries (having access to IDA's soft window or a blend of World Bank/IDA funds).* A relevant taxonomy should take into account not only present GNP per head but also other economic and social indicators as already mentioned, the availability of natural resources and different institutional environments.** Developing countries

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* According to World Bank terminology. Upper middle-income countries average GNP per capita was US$2,490 current dollars in 1981 and lower middle-income countries average GNP per capita was US$850. Industrial market economies average GNP per capita was US$11,120 in the same year. In contrast low-income economies average GNP per capita was of US$270.

**It would for instance be a mistake to try to foster in Latin America the emergence of export platforms in the Southeast Asian style as there are effective limits to this policy stressing the importance of maintaining the relative balance between domestic firms and foreign firms which would be extremely difficult to dodge. A hardening of developed countries policies intended to weaken the position of domestic firms is likely to be counterproductive in the long run.

should be divided into at least four main groups: the very poor countries, the developing countries without a minimum natural resource basis in relation to their population, those having an adequate resource basis which could make them viable in the long run with relatively less help from the rest of the world, and the export platforms, given their lack of an important domestic market and their special links with developed countries.

Criticisms are not restricted to the "theoretical" concept of graduation but apply also to the difficulties of defining an adequate trigger point variable so as to make the concept operational. The World Bank has been using until 1982/83 a GNP per head threshold as the trigger point to review a country's case and develop a "graduation program to end lending subject to access to capital markets on reasonable terms and the extent of progress in establishing key institutions for economic and social development"*. Other Bank statements are less careful as, in spite of conciliatory admissions that "access to capital markets can change dramatically due to circumstances outside the country's control", it is asserted that "experience has shown that when countries reach the per capita GNP trigger level they are likely to have gained access to private capital markets"**. The Bank's most recent statements on the subject, while being much more careful to qualify their assertions, on the whole tend, as already mentioned, to confirm previous graduation tenets.

GNP per capita has several limitations. Given the same level of GNP per head different countries can show considerable heterogeneity; some countries in the graduation fringe present economic and social indicators which are akin to those of other developing countries not ~~menaced with the prospect of graduation, especially income distribution~~

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* World Bank Annual Report, 1982, p. 35.

** Graduation from the Bank Memo, p.3.

In the case of trade preferences, the application of a single GDP per head thereshold is even more objectionable. In this case most pro-graduation arguments relate to the degree of competitiveness in certain product lines. This, however, can provide little consolation for those willing to produce an objective criteria of graduation since there is as yet no objective definition of "competitive need" or "market disruption" which does not resort to some kind of protectionist argument.

A criterion based on a number of social and economic indicators would of course be in principle less subject to criticism than the simple consideration of GNP per head statistics. But such a criterion would have an important inconvenient from the point of view of those countries interested in the adoption of graduation procedures in the short run: it would have to be negotiated as no simple answer is forthcoming on the weights to be used to compute an index to serve as a graduation criterion. Once the negotiations open,the problem is bound to be politically discussed.

VI. The Costs of graduation

In this section the costs of graduation for a developing country in both finance and trade are discussed and an attempt is made to estimate such costs for Brazil under hypothetical scenarios of graduation from the World Bank and the major GSP schemes. It is also pointed out that graduation also entails significant "boomerang effects" for the developed countries.

Costs related to graduation in the World Bank and in various GSP schemes are by very far the main losses likely to be suffered by developing countries. In relation to them, the magnitude of other graduations costs, as for instance those related to the reduction of technical cooperation transfers through UNDP resulting from the concentration of resources in the poorer developing countries is not very significant*. However, it is to be noted that UN-system technical cooperation has played a positive and at times essential role in the past decades, especially where the developing countries concerned have had the capacity to be selective and to absorb and use the skills and technology transferred to them.

Beyond this, and perhaps more importantly, the continued participation of middle-income countries in multilateral technical cooperation programmes encourages the development of South-South links which,by themselves, have major political significance. In fact, there may be a need to rethink the role of middle-income countries in multilateral technical cooperation not in the sense of their exclusion or discrimination, but of a much greater involvement. In such a perspective, middle-income countries can eventually be expected to contribute more, to the point of becoming "net contributors" to programmes such as UNDP. However, this implies that they should be given a more active role in formulating and managing these programmes, a bigger share in the orders generated by technical assistance and perhaps ensure that cooperation involving interaction between developing countries be more effective than traditional methods of North-South assistance.

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* This can be verified by comparing the estimates of potential losses from World Bank and GSP graduation shown below with UNDP yearly expenditures in Brazil in 1981-82 of US$8-9 million dollars, Statistical Annex, Annual Report of the Administrator for 1982, UNDP Governing Council DP/1983/6/Add.4, 28.4.83.

The costs of graduation from the World Bank: the case of Brazil

What are the costs implied by financial graduation? Supposing that - as the World Bank suggests - there is in fact the possibility of borrowing in private capital markets sums equivalent to the World Bank displaced loans, the costs of graduation refer to the direct costs of paying higher interest rates and the indirect costs of the deterioration of the foreign debt profile as World Bank terms tend to be more favourable than average private loans (longer grace and repayment periods).

Direct costs are simpler to compute than indirect costs. Table 3 shows the difference between market interest rates and World Bank loans interest rates in recent years: costs of graduation would depend among many other things on the characteristics of the debt profile and on the year of graduation. Since the World Bank only recently changed its policies and introduced a new variable interest rate lending

TABLE 3

World Bank loans to Brazil, 1974-1983

Fiscal year ending on the 30th of June of	Approved Loans US$10^6*	Weighted equivalent average interest rate (%)*	LIBOR 6-month**** (%)	Brazilian Spread***** (%)
1974	242	7.25	10.2	1.1
1975	426.5	8.14	6.6	1.7
1976	498	8.55	5.4	1.9
1977	425	8.42	7.6	2.0
1978	755	7.49	12.5	1.7
1979	624	7.51	14.8	1.0
1980	695	8.25	16.4	1.3
1981	844	9.35	16.7	> 2.3
1982	722.1	11.60**	13.4	> 2.3
1983	1475.5	- ***	9.9	> 2.3

* World Bank Annual Report, several years.

** A front-end tax of 1.5% of the total loan was introduced in early 1982, reduced to 0.75% in December and to 0.25% in March 1983.

*** Variable rate: pre-1.1.83, 11.43%; 1.1.83 to 6.30.83, 10.97%; after 6.30.83, 10.47%.

**** Conjuntura Econômica.

***** P.N. Batista Jr., op.cit., p. 118 and S. Edwards, LDC's Foreign Borrowing and Default Risk: an Empirical Investigation 1976-1980, NBER, Working Paper nº 1172.

policy in contrast with its fixed - if increasingly more frequently revised - interest rate policy up to mid-1982, countries who graduated before the 1978-1980 lost quite heavily as the costs of paying interest on commercial loans increased to 15% or more while interest rates on bank loans remained around 8%.After the introduction of the variable rate lending system losses of graduation countries are bound to be less important.The Bank charges a 0.5% spread over its own borrowing costs (partly actual,partly estimated);this should be compared with "normal" effective spreads of at least 4%* in the case of Brazilian post-1981 loans in the private sector.For a hypothetical loan of,say,2 years grace and 10-year repayment period,supposing a stable Libor of 10%,there is a grant element of more than 17% (the lower, the higher the prospective LIBOR) of the nominal amount of the loan.**

"Indirect" costs of not qualifying to receive World Bank loans are very difficult to compute but they certainly are not insignificant as the terms of World Bank loans (grace and repayment periods) are better than those typical of alternative loans consequently affecting the foreign debt profile and ceteris paribus,the cost of servicing the debt.*** There is moreover the additional cost of losing the improved creditworthness that the market may attach to a country being a recipient of World Bank loans.

The initial assumption of the analysis based on comparative interest costs - that there is the actual possibility of borrowing in the international capital markets in substitution of World Bank loans - is rather strong. Indeed it may be the case that alternative borrowing is blocked whatever the spread a given country is prepared to pay.The main question here then is not to assess the increased costs

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* On "effective" Brazilian spreads over LIBOR see P.N.Batista Jr.,Mito e Realidade da Dívida Externa Brasileira,Rio de Janeiro, 1983, p.120.

** Access to IDB Loans entails similar advantages to Brazil, total loans being of course only about a fourth of IBRD Loans.It is unlikely,however,as already mentioned that IBRD-type graduation is introduced in the near future by IDB.

***See S. Edwards,op.cit.,where the relation between spread and its explanatory variables is examined in a cross-section regression for 19 countries for 1976-1980.

of borrowing equivalent to the cut in World Bank financing due to graduation: the crucial question concerns availability not comparative borrowing costs.

If it is supposed that Brazil had been graduated before facing the recent balance of payments crisis the contraction in foreign borrowing would entail a severe cost in terms of decrease in the level of activity as imports would have to be further cut. Rough estimates suggest that additional import cuts will cost a 1% fall in GDP per US$500 million cut in the import bill.* Abstracting from complications - related to phasing out and the divergence between the total of approved loans and actual disbursements - and supposing World Bank disbursements to be of the order of US$1.5 billion in 1984** a cut of such loans would entail a further reduction in GDP of almost 3%.

The costs of graduation from the major GSP schemes: the case of Brazil

The costs of commercial graduation results from withdrawal of GSP treatment by donor-countries. The costs of graduation of a particular product from a developing country in a GSP scheme are incurred through the fall of exports of the graduated product to the GSP-donor country caused by the loss of the competitive price advantage given by duty-free treatment under the preferential scheme.***

* See M. de P.Abreu and M.H.T.T. Horta, Demanda de Importações no Brasil, 1960-1980: Estimações Agregadas e Desagregadas por Categoria de Uso e Projeções para 1982, Texto para Discussão Interna nº 48, IPEA/INPES, Rio de Janeiro, 1982.

** This corresponds to about 25% of the expected net transfer of resources implied in the Brazilian adjustment program for 1984.

***Certain GSP imports are not allowed duty-free entry under some schemes. These, however, represent a very small fraction of total GSP imports in such schemes.

The price effect and the overall fall of the imports of the graduated product-country pair to the donor country can, for analytical purposes, be decomposed into a Trade Contraction effect, resulting from the substitution by domestic production, and a Trade Diversion effect, caused by the substitution by imports from third sources.

Under the usual assumption of infinite supply elasticity of exports of donor-country suppliers, the Trade Contraction effect of the graduation of product-class i can be written as:

$$TC_i = e_i t_i M_i^o m_i \qquad (1)$$

where:

- e_i represents the price elasticity of imports of product-class i,
- t_i is the competitive price advantage lost by the change of MFN tariff t_i on a product previously imported duty-free under the GSP*
- M_i^o are the imports of product-class i from the graduating country, and
- m_i is the share of imports of product-class i from the graduating country which effectively enjoyed duty-free GSP treatment prior to graduation.

The Trade Diversion effect can be calculated using a cross-price elasticity of substitution of imports of product-class i from the beneficiary country by imports from other - preferred and non-preferred - sources in the GSP-donor country

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* Note that this represents the percentage variation in the import price-plus-tariff cost of product-class i imports from the graduating country.

markets, E_i, defined as:

$$E_i = \frac{\Delta\left(\frac{M_i m_i}{MOS_i}\right)}{\left(\frac{M_i^o m_i}{MOS_i^o}\right)} \cdot \frac{1}{t_i} \qquad (2)$$

where MOS_i stands for the imports of product-class i from other sources. Noting that, by definition, Trade Diversion can be written as:

$$TD_i = M_i^o m_i - M_i m_i = MOS_i - MOS_i^o \quad (3)$$

and substituting (3) into (2), one finds that the Trade Diversion effect can be calculated as:

$$TD_i = \frac{(1-S_i)S_i E_i t_i m_i}{1+S_i\left\{m_i(E_i t_i+1)-1\right\}} \cdot MD_i \quad (4)$$

where:

S_i is the share of imports from the graduating country in total donor-country imports of product-class i, and

MD_i represents total donor-country imports of product-class i.

The above methodology can be applied to calculate the total trade loss that can be inflicted upon a large developing country such as Brazil by the graduation of its preferred exports by adding up the losses incurred in all of its effectively GSP - eligible products.

A precise estimate of this effect should be based on calculations carried out at the lowest level of aggregation - if possible, at tariff-line level. However, the order of magnitude of the losses involved can be obtained by considering just two broad classes - agricultural and industrial - of exports from Brazil for which average values for the relevant parameters can be calculated using 1979 trade data.

The results of these calculations are presented in Table 4, below. It is calculated that the overall effect of graduation from the major three GSP schemes, would represent a loss of about 2.83 per cent of the value of total Brazilian exports. Applied to 1983 trade data this would amount to an yearly loss of US$345 million at 1983 prices (Table 4 about here).

The Costs of Graduation to Developed Countries

As shown above, financial graduation involves, in the best possible circumstances, increased interest payments and deterioration in the profile of the foreign debt of developing countries. Commercial graduation, on the other hand, results in the reduction of exports by those countries due to the combined effect of trade contraction and trade diversion.

In a period of normalcy in world credit markets such yearly foreign exchange losses can in principle be compensated by increased indebtedness: the deterioration in the current account of the balance of payments is compensated by improved results in the capital account. Since mid-1982, however, this accommodation has become

TABLE 4

BRAZIL: 1979

Trade Losses from graduation from the major GSP schemes
(in US$ thousands)

GSP Donor and Product Class	Trade Contraction	Trade Diversion	Total Trade Loss
USA			
Agricultural	9231	10494	19725
Industrial	88181	37917	126098
Total	97412	48411	145823
EEC			
Agricultural	24161	64530	88691
Industrial	7760	10061	17821
Total	31921	74591	106512
Japan			
Agricultural	2884	5653	8537
Industrial	6189	4963	11152
Total	9073	10616	19689
Total			
Agricultural	36276	86777	116953
Industrial	102130	52941	115071
Total	138406	133618	272024

Source: Authors' estimates. Sources used for estimation of relevant parameters and variables were as follows:

M_i^o - 1979 World Trade Annual, prepared by the Statistical Office of the United Nations, Volumes I to V, Walker & Co, New York.

MD_i - idem.

t_i - calculated using weights based on Brazilian imports and donor-country pre-Tokyo Round average tariffs given in A.J.Yeats, Trade Barriers Facing Developing Countries, Macmillan, London, 1979, Table 4.3., pp.76-77. The fall in average tariffs since the Tokyo-Round should mean that the trade effects presented here are slightly overestimated.

m_i - for the U.S. and Japanese GSPs, data for Brazil from UNCTAD, Trade and Development Board, Replies Received from Preference Giving Countries. For the EEC scheme, the average for all beneficiary countries presented in Table 2 was used.

e_i - average of import elasticities for the U.S., EEC and Japan presented in W.Cline et.al., op.cit., p. 58.

E_i - substitution elasticities from B.G.Hickman and L.J.Lau, Estimates of Elasticities of Substitution for Commodity Imports Disaggregated According to Project Link Classification, mimeo, Stanford University, August 1974, given in W.Cline et.al, op.cit., pp.62-63.

In aggregating the trade data, "Agricultural" products were considered as falling under chapters 1 to 24 of the CCC Nomenclature and SITC Divisions 0,1,2 and 4, while "Industrial" products are these under chapters 25 to 99 of the CCCN and SITC Divisions 3 and 5 to 8.

impossible for many countries which are candidates to graduation. Increased foreign debt costs and decreased exports have to be compensated not by "improved" capital account results but by deep changes in the current account achieved, to a large extent, through the imposition of tight import controls. Such import constraints are bound to be associated with a fall in output especially in semi-industrialized countries which depend heavily on intermediate goods imports. This happens over and above the fall in imports, related to the fall in activity induced by macroeconomic adjustment policies designed to "solve" the balance of payments problems created by the sudden changes in the rules of the international financial market game in 1982.

Contraction of developing countries imports will, of course, have a direct unfavourable impact on their suppliers. In the case of Brazil it is to be expected - supposing that trade contraction will not affect the country composition of Brazilian imports - that imports from developed countries will decrease by about 50% of the total import bill reduction. Instantaneous graduation in the financial sphere with no alternative borrowing facility would thus involve as direct cost a reduction of US$750 million in the exports of developed countries to Brazil , while instantaneous graduation from all major GSP schemes would wipe out a further US$180 million.*

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* This is of course very much in the mind of some developed countries' policy-makers. See for instance Ambassador Brock answering Senator Dole in Renewal of the Generalized System of Preferences, Hearing before the Subcommittee on International Trade of the Committee on Finance, United States Senate, 98th Congress, 1st session, August 4 1983: "the complete removal of beneficiary countries from the GSP at this time will not only ignore the affected beneficiaries' development needs, but would also be contrary to U.S. economic interests... In 1982 the GSP's top seven beneficiaries purchased over $30 billion of US exports, representing 15 percent of global US exports. Perhaps more importantly, U.S. exports to the leading beneficiaries grew at an annual rate of 14.7 percent during 1976-82, as compared to the 9.6 percent growth rate recorded in U.S. exports to developed countries".

To these costs must be added those indirect costs to developed countries related to the fall of Brazilian imports from other developing countries which will affect their activity levels and consequently also their imports from the developed countries.* In both cases secondary effects would have to be taken into consideration: lower exports by developed countries mean lower levels of activity and reduction in their import demand, fall in world commodity prices, further deterioration in the balance of payments of developing countries.

It is perhaps insufficiently understood by wide circles in the developed countries that the flow of real resources from developing countries since 1982 - in contrast to a sizeable flow of real resource to these countries in previous period - is made possible by the generation of large trade surpluses with the developed countries and that this is the only possible way - barring a reduction in interest payments - to adjust to the new conditions in the private capital markets.

In the case of countries such as Brazil which depend crucially on oil imports it is difficult to imagine that, in the near future, it will be possible to reduce their deficits in the bilateral trade with oil exporters especially in the Middle East. The only way to improve the aggregate trade balance in order to compensate for the contraction of capital inflows is thus to increase trade surpluses in markets other than those of oil exporters. As other developing countries are generally going through the same plight as Brazil this

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* The American and Japanese economies are particularly dependent on the demand of non-developed countries imports which make up respectively 59% and 51% of their total exports. The CEE on the other hand relies very considerably on intra-trade which accounts for 54% of its total exports.

means that bilateral trade surpluses have to be generated in the markets of developed countries.

Consequently, in the absence of a return to normalcy in private financial markets, graduation with its consequences of withdrawal of advantageous terms in the World Bank and of preferences in GSP schemes would make it very difficult for developing countries to continue to honour their financial commitments as there are political limits to the alternative of further contraction of imports.

Consequently, the adoption of graduation policies in the foreseeable future is likely to damage not only the economies of directly affected countries but also the other members of the international community. It is indeed ironical that the foreign economic policies of developed countries which pretend to be the defenders of economic liberalism should constitute such a menace of the multilateral system on whose operation hinges the speed of recovery of the world economy. If arguments related to equity are not sufficient to impose restraints on graduation policies self-interest should be allowed to impose limits to the costs of such policies for the world economy as a whole.

VII - Conclusions

1. The rise of the concept of graduation entails the abandonment of the main tenet of North-South economic relations until the late 1960s, viz. that, by reason of some of their economic specificities, developing countries should be entitled to special, differentiated and more favourable treatment. This can be explained rather by the developed countries' increasingly narrow view of multilateral

relations, than by the alleged need for better allocation of the benefits derived from such preferential treatment towards the least developed among developing countries.

2. Although the concept of graduation remains loosely defined and consequently cannot be translated into an unambiguous operational procedure this has not prevented its application in the realms of GSP agreements and World Bank hard window loans. However, in spite of its practical application, the concept of graduation faces a problem of legitimacy since it is a specificity - stressing differences among developing countries - which has been imposed by developed countries. Such attempt at imposing a specificity is unacceptable, since it runs against the very operational objective of the notion of specificity which is, as discussed at the onset of Section II, to enhance cooperation. This is the origin of the two main criticisms which have been levelled on purely a priori grounds against graduation as applied in practice, i.e., that it is both unilateral and arbitrary. Unilateral because it has been applied without negotiations between all concerned parties. Arbitrary because it has been based on excessively simplified criteria concerning the definition of a threshold between development and underdevelopment.

3. The definition of mutually agreed norms for the application of graduation therefore pressuposes negotiations and consultations involving the developing nations.

These should take place as two distinct levels. First and foremost, the relevant specificities which can be relevant for a

meaningful application of the concept in the several areas in which it has arisen should be defined in North-South negotiations conducted in such a way as to preserve the basic identity sustained by the Group of 77. A tentative agenda for such negotiations might possibly include, as suggested by Helio Jaguaribe, reserving financial grants exclusively to the least developed countries which should also have preference - though not exclusiveness - in the distribution of technical assistance and multilateral banks' credits. The less poor among developing countries would, in turn, be guaranteed access to OECD markets and, on an ad hoc basis, to technical assistance and MDB loans in socially desirable projects whose feasibility depended upon access to those forms of assistance.

Complementarily, there should be North-South negotiations within the framework of multilateral organizations to define objective criteria of application or negotiating procedures aimed at eliminating the possibility of the present arbitrary and unilateral forms of graduation.

4. These negotiations should take into account that there are important costs involved in graduating developing countries both for these countries and for their main suppliers. The main costs result from trade diversion and contraction due to the loss of GSP status as well as from the cutting off of access to World Bank loans. The costs incurred by the graduating countries' suppliers are considerably enhanced by the present difficulties facing most middle income developing countries in their access to private financial markets. Rough estimates for the case of Brazil indicate

that in the present conditions abrupt graduation from the World Bank and the major GSP schemes would have resulted in a reduction of foreign exchange earnings of the order of US$1,850 million dollars in 1983. This in turn would entail a reduction in Brazilian imports from developed countries of approximately US$930 million.

While the World Bank reacted in a positive way to changed conditions in the World economy since mid-1982 by practically doubling the total of its loans to Brazil there was no explicit reformulation of the accepted wisdom on graduation in the bank or in other areas in which the concept has been heard of. It should be expected, however, that given the present world economic conditions, self-interest should be allowed to prevail and the imposition of graduation consequently be indefinitely postponed.

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1980/1984

01. Lara Resende, A. "Incompatibilidade Distributiva e Inflação Estrutural".

02. Malan, Pedro S. "Desenvolvimento Econômico e Democracia: A Problemática Mediação do Estado".

03. Bacha, E.L. "Notas sobre Inflação e Crescimento: Um Texto Didático".

04. Lopes, Francisco L. "On The Long-Run Inflation-Unemployment Trade-Off".

05. Williamson, J. "World Stagflation and International Monetary Arrangements".

06. Lara Resende, A. e Lopes, Francisco L. "Sobre as Causas da Recente Aceleração Inflacionária".

07. Camargo, J.M. "A Nova Política Salarial, Distribuição de Rendas e Inflação".

08. Bacha, E.L. e Alejandro C.D. "Financial Markets: A View from the Periphery".

09. Modiano, E.M. e Lopes, Francisco L. "Dilemas da Política Energética".

10. Bacha, E.L. e Lopes, Francisco L. "Inflation, Growth and Wage Policy: In Search of a Brazilian Paradigm".

11. Monteiro, J.V. "A Economia do Crescimento do Setor Público".

12. Modiano, E.M. "A Three-Sector Model of a Semi-Industrialized Economy".

13. Modiano, E.M. "Derived Demand and Capacity Planning Under Uncertainty".

14. Lopes, Francisco L. "Rational Expectations in Keynesian Macro-Models".

15. Camargo, J.M. "Reflexões sobre o Ensino da Economia".

16. Camargo, J.M. "Brazilian Size Distribution of Income and Governmental Policies".

17. Modiano, E.M. "Energy Prices, Inflation and Growth".

18. Modiano, E.M. "Estratégias de Racionamento: Uma Generalização".

19. Bacha, E.L. "Recessão, Balanço de Pagamentos e Crescimento".

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22. Arida, P. "The Division of Labour as a Search Process".

23. Lopes, Francisco L. "Stabilization Policy, Rational Expectations, and Staggered Real Wage Contracts".

24. Correa do Lago, L.A. "Balança Comercial, Balanço de Pagamentos e Meio Circulante no Brasil no 2º Império: Uma Nota para Uma Revisão".

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28. Lopes, Francisco L. "Rational Expectations, Discrete Price-Setting and the Role of Monetary Policy".

29. Malan, P.S. e John R. Wells; "Structural Models of Inflation and Balance of Payments Desequilibria in Semi-Industrialized Economies: Some Implications for Stabilization and Growth Policies".

30. Abreu, Marcelo P. "Anglo-Brazilian Economic Relations and the Consolidation of American Pre-Eminence in Brazil: 1930/1945".

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32. Diaz-Alejandro, C.F. "The LDCs in the 1982 International Economy: Two Comments".

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36. a) Abreu, M.P. e W. Fritsch; "As Lições da História: 1929-33 e 1979-8?".

    b) Lara Resende, A. "A Ruptura no Mercado Internacional de Crédito".

    c) Correa do Lago, L.A. "A Programação do Setor Externo em 1983: Uma Breve Análise Crítica".

    d) Carneiro, D.D. "O Terceiro Choque: É Possível Evitar-se a Depressão?".

e) Lopes, F.L. "A Crise do Endividamento Externo: Alguns Riscos e suas Consequências".

f) Malan, P.S. "Recessão e Renegociação".

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h) Bonelli, R. "Investimento e Emprego Diante de Desequilíbrios Externos e Internos".

i) Modiano, E.M. "Choques Externos e Preços Internos: Dificuldades da Política Econômica".

j) Monteiro, J.V. "Organização e Disfunções da Política Econômica".

k) Bacha, E.L. "Por uma Política Econômica Positiva".

l) Camargo, J.M. "Do Milagre à Crise: A Economia Brasileira nos Anos Oitenta".

m) Arida, P. "Austeridade, Autotelia e Autotomia".

37. Lopes, F.L. e E.M. Modiano; "Indexação; Choque Externo e Nível de Atividade: Notas Sobre o Caso Brasileiro".

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43. Werneck, R.F. "Expansão de Exportações, Substituição de Importações e Crescimento Setorial: A Experiência dos Anos 70".

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58. Arida, P. "Social Differenciation and Economic Theory".

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62. Fritsch, W. "Brazil and the Great War, 1914-1918".

63. Arida, P. e A.L. Resende; "Recession and the Rate of Interest: A Note on the Brazilian Economy in the 1980's".

64. Abreu, M.P. "Notas Sobre Algumas Fontes Primárias Estrangeiras para a História Econômica Brasileira".

65. Arida, P. e E. Bacha; "Balanço de Pagamentos: Uma Análise de Desequilíbrio para Economias Semi-Industrializadas".

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70. Modiano, E.M. "Elasticidades-Renda e Preço da Demanda de Energia Elétrica no Brasil".