DISCUSSION PAPER NO 6

The Trade, Debt and Finance Nexus: at the Cross-roads of Micro- and Macroeconomics

by

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ABSTRACT

Trade liberalization is only one facet of the opening up of developing countries to the global economy. After a couple of decades of financial deregulation, liberalization of private capital movement and accumulation of debt at the international level, developing countries are raising issues of, if not incompatibility, at least sequencing and timing of the process of liberalization of capital movements and the process of liberalization of trade in goods and services. The consequences of the liberalization of both financial and "real" transactions is of increasing concern, particularly in emerging economies (i.e. successful integrators in the world economy), after a succession of financial crises in the 1990s (from Mexico to Asia, and some countries in South America), and with severe spill-over effects on growth and trade. Also, poor and very indebted countries face difficulties to integrate into world trade due to a lack of access to private capital markets, debt overhang, and deterioration in the terms of trade. The relationship between trade, debt and finance is equally important for them, and is part of the holistic policy environment which leads to development.

This paper seeks to provide some clarification of this multi-faceted and complex relationship, and how the WTO is part of a national and international effort to address some of the challenges raised by these relationships. The paper reviews some of the theoretical links and existing literature on the subject, and analyses practical steps and priorities that are directly addressed in the newly established Working Group on Trade, Debt and Finance of the WTO. Finally, the paper addresses the issue of Coherence in the work of international organizations on some of the links highlighted in the first section.

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I. INTRODUCTION

Considerable progress has been made since the late 1980s in liberalizing trade policies, in both developed and developing countries. Trade policy reform has been the outcome of a mix of unilateral, regional and multilateral initiatives, in varying measures across countries and regions. Broadly speaking, the industrial countries have relied mainly on the multilateral process under the WTO and on regional integration initiatives to generate a positive environment in favour of more liberal trade. In contrast, unilateral reform has primarily been a feature in developing, newly industrialized, and transition economies. At the same time, in many parts of the developing world, the process of trade liberalization has only been one facet of a wider opening up of the economy to external flows of goods, services and capital. In some cases (central and eastern European countries and Baltic countries), governments have taken decisive steps to reverse quasi-autarkic policies applied in the context of centrally planned systems. In other cases, such as Latin America, trade and financial liberalization have become symbols of economic progress, after years of inward-looking, import substitution policies supported by exchange controls.

The economic logic behind simultaneous or phased removal of obstacles to the flows of goods, services and capital (including foreign direct investment) suggests that the expansion of trade needs reliable, adequate and efficient financing, both long-term (for investment in tradable goods and services) and short-term (financial instruments). An efficient and open domestic banking system at local and international level is key to providing financing as well as financial services related to trade and direct investment, thereby permitting the expansion of international trade of goods and services. An important issue in this respect is balancing the advantages that can accrue from liberalizing trade in financial services with the need to ensure that liberalization is properly timed, sequenced and prudentially managed so that it does not become a source of financial instability in its own right.

However, the experience of liberalizing capital, in particular portfolio investment and short-term financial instruments in the developing world, has been unstable. Despite efforts to sequence financial liberalization, successful integrators in both world trade and finance experienced financial and exchange rate crises of a previously unknown magnitude, with strong contagion effects on growth, employment and social conditions in the crisis-stricken countries. In the run-up to the Seattle Ministerial Conference, a number of these countries requested the establishment of a dedicated working group in the WTO to examine the relationship between trade, debt and finance, and eventually come up with conclusions that could involve WTO action.[1] Although the Working Group's mandate is somewhat general, it addresses the concerns of developing countries that their trade opportunities and policies were being undercut by international financial problems that have emerged with liberalization, most importantly unstable capital flows and the threat of recurring financial crises, and unsustainable foreign indebtedness. Fears of contagion spreading from the financial sector to the real economy have developed with the experience of financial crises. More recent financial shocks and crises in Latin America have strengthened the view of many developing countries that global crises should be met by global (or at least better coordinated) policy responses covering not only debt and finance but trade as well. Many of the poorest developing countries (in Africa, the Caribbean, and some countries in Central America), which do not have access to financial markets, support WTO work in this area especially linking their integration into the trading system with the reduction of their debt burden. There is a sense that international initiatives to reduce indebtedness through debt relief (the HIPC Initiative) are only one component of a more global strategy that should focus on increasing market-access and developing supply-side capacities.

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[1] The Group's mandate, from the Doha Ministerial Declaration, paragraph 36, reads as follows:

"We agree to an examination, in a Working Group under the auspices of the General Council, on the relationship between trade, debt and finance, and of any possible recommendations on steps that might be taken within the mandate and competence of the WTO to enhance the capacity of the multilateral trading system to contribute to a durable solution to the problem of external indebtedness of developing and least-developed countries, and to strengthen the coherence of international trade and financial policies, with a view to safeguarding the multilateral trading system from the effects of financial and monetary instability. The General Council shall report to the Fifth Session of the Ministerial Conference on progress in the examination".

This paper seeks to address key aspects of that relationship based on the work of the WTO Secretariat and on recent economic literature,[2] as well as recent policy experiences. Section II looks at various aspects of the relationship between trade and finance, focusing in particular on ways in which trade can be affected by financial instability, with reference to the financial crisis in emerging market economies throughout the 1990s, and describes efforts underway to strengthen the international financial system in the wake of that crisis. Section III looks at the relationship between trade and debt (and vice versa), focusing on the ways in which a Member's trade and their integration into the multilateral trading system can be affected by external debt, and how high indebtedness may in turn defeat efforts by Members to build strong export-led economies. Section IV looks at what could be done among international organizations to build greater policy coherence under these relationships and reviews recent concrete steps on issues that had been identified by the Working Group. Section V discusses future work on some of these issues in the WTO, while Section VI summarizes the bibliographical references contained in the various sections.

[2] Refer in particular to WTO Documents WT/WGTDF/W/4 and W/9.

II. THE RELATIONSHIP BETWEEN TRADE AND FINANCE, AND THE ROLE OF THE WTO

The most important relationship is between exchange rates and trade, financial flows and trade and balance-of-payments adjustment and trade.

A. EXCHANGE RATES AND TRADE

Traders and trade officials depend on a stable international price mechanism for conducting cross-border transactions, for taking decisions on investment and production of tradable goods and services, and for setting price-based trade policies. The uncertainty generated by small, short-term fluctuations in nominal exchange rates generates commercial risk, but it can generally be tackled effectively through financial hedging. Wider and deeper fluctuations in exchange rates, and sustained misalignment of exchange rates away from levels that reflect inflation rate differentials, send incorrect price signals which can destabilize international trade flows (Dell'Ariccia, 1998). This increases uncertainty for traders that often cannot be (or is too costly to be) hedged effectively.[3] It can inflict adjustment and resource misallocation costs on an economy if it changes investment decisions and results in shifts of resources between the tradable and non-tradable sectors of an economy that are not justified by relative cost and productivity differentials. It can destabilize levels of protection against foreign competition provided by price-based trade restrictions, and generate pressure for compensating trade restrictions to protect current patterns of supply (IMF, 1984). Exchange rate volatility can be a channel for instability to spread from the financial to the real sectors of an economy.[4] Large exchange rate fluctuations can disrupt trade by creating inflationary pressures, by causing large private capital movements that are not justified by underlying fundamentals in the real economy, and by hindering the capacity of countries to repay foreign debt.

In a recent update of its 1984 study, the IMF looked at the issue of exchange rate volatility over a period of twenty years and for both developed and developing countries (IMF, 2004).[5] It comes to two conclusions: (1) while exchange rate fluctuations increased in times of currency and balance of payment crises, on average volatility was no greater in the 1990s than in the 1970s (although the later period was quite high relative to the times of the Breton-Woods system); (2) while empirical results point to some relationship between exchange rate volatility and trade, this effect is seen as relatively small and should be nuanced due to the lack of robustness of econometric results, although it is made clear that "exchange rate fluctuations increased in times of currency and balance of payments crises during the 1980s and 1990s" (p.6). The study also indicates that "at an aggregate (world) level, there is no evidence of a negative effect of exchange rates on world trade, but once one goes to trade and exchange rate volatility at the bilateral level a negative relationship is borne out by some of the empirical evidence in this study" (p.8). In sum, exchange rate volatility is more likely to affect regional trade, than world trade, an outcome which is consistent with recent economic literature, mentioned in the study, in particular work by Rose and Dell'Ariccia (1998, Id).[6]

B. FINANCIAL FLOWS AND TRADE

The expansion of trade depends on a reliable, adequate and efficient source of financing, both long-term (for investment in tradable goods and services) and short-term (financial instruments that

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[3] In many developing countries, traders do not have access to hedging. Forward contracts allowing for hedging are available mainly in developed countries markets, for minimum amounts of US$500,000.

[4] WT/GC/W/444.

[5] J-Y Wei, P. Clarke, N. Tamirisa and al. (2004), The Impact of Exchange Rate Volatility on Trade Flows, IMF, Washington DC, circulated in the WTO as Document WT/WGTDF/W/24.

[6] Dell'Ariccia provides a systematic analysis of exchange rate volatility on bilateral trade among 15 EU member States and with Switzerland. It concludes that eliminating volatility to zero in the most "volatile" year would have increased trade by 10-13 per cent. Rose conducted a wider study over 20 years involving 186 countries, and found similar results. Reducing volatility by one standard deviation around the mean would increase bilateral trade among these countries by 13 per cent, the same percentage revealed by Rose (p.13, paras. 30-32).

allow "real" transactions to be protected from instability in asset prices, and for trade-financing). However, most developing countries remain heavily dependent on foreign sources of finance. Private capital flows became a far more important source of foreign finance for developing countries in the 1990s than official capital flows, and foreign direct investment (FDI) and portfolio investment (bond and equity financing) became more important relative to bank lending, particularly in the emerging market economies (Table 1). According to UNCTAD, in the mid-1980s international bank lending accounted for over 50 per cent of total private capital flows to developing countries, FDI for 22 per cent, and foreign portfolio investment for 18 per cent.[7] The data in Table 1 show that by the mid- to late-1990s their respective shares were about 14 per cent for bank lending, 52 per cent for FDI, and 34 per cent for foreign portfolio investment. FDI exceeded foreign portfolio investment (including sovereign and public bond financing) in developing countries in all years except 1993, and in most developing countries FDI flows are a significantly more important source of foreign financing than foreign portfolio investment flows. Both bond and equity portfolio investment fell sharply at the time of the Asian financial crisis, but equity investment flows proved the more resilient of the two, recovering again in 1999 and 2000. They account now for around 15-20 per cent of private capital flows to developing countries.[8]

The fact that foreign portfolio investment is found to be more variable than FDI, because portfolio investors generally have a shorter time horizon and are able to liquidate their investments more easily, does not necessarily imply that it is inherently "volatile". The difference between variability and volatility is in practice mainly one of degree. However volatility carries with it also the notion of large, more frequent, and unpredictable changes in the volume of capital inflows and outflows. When this happens, it can destabilize the domestic investment environment and be highly detrimental to growth, development and macroeconomic management in the host country.[9] Sudden and significant changes in foreign investment can undercut monetary, fiscal and exchange rate policies. They can also affect the availability of finance, and consequential changes in its cost and in asset prices, which makes investment planning difficult. Large capital inflows create excess liquidity in the domestic financial system, which can encourage asset bubbles and increase speculative investments, while outflows drain liquidity from the system and can threaten the viability of otherwise perfectly sound investments.

The 1990s saw emerging market economies register a sharp increase in inflows of foreign portfolio investment with some of these economies experiencing serious financial crises. Clearly, the behaviour of foreign portfolio investors contributed to both the timing and the amplitude of the financial crises. At the same time, it would be simplistic to draw the conclusion that financial crisis is an inevitable consequence of allowing increased flows of foreign portfolio investment. By and large, it seems likely that most categories of foreign portfolio investors (other than perhaps those operating at the most speculative end of the market) are as averse to volatile capital market conditions as are the governments and private enterprises of recipient countries, and that both have an equal interest in seeing regulatory measures taken, and policies put in place, to limit volatility.[10]

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[7] TD/B/COM.2/EM.6/2, and Corr.1 of 15 April 1999.

[8] See World Bank, *op cit*, p. 46; 15 per cent based on capital market commitments, and 18 per cent based on net long-term resource flows.

[9] For an analysis of the causes and effects of portfolio investment volatility, see UNCTAD: "The Growth of Domestic Capital Markets, Particularly in Developing Countries, and Its Relationship with Foreign Portfolio Investment" (TD/B/COM.2/EM.4/2, 19 March 1998) and "Foreign Portfolio Investment: Implications for the Growth of Emerging Capital markets" (UNCTAD/GDS/GFSB/4, 9 September 1998), and World Bank *Global Development Finance 2001*, pp. 71-76.

[10] For a discussion of policy options to address volatility, see World Bank *op cit* and UNCTAD/GDS/DFSB/5, pp. 38-39.

Table 1: Selected net long-term resource flows to developing countries, 1991-2000, (US$ billions)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Total of which:	123.0	155.8	220.4	223.7	261.2	311.2	342.6	334.9	264.5	295.8
Private flows of which:	62.1	99.3	166.8	175.7	206.1	279.3	299.8	280.3	219.2	257.2
FDI	35.7	47.1	66.6	90.0	107.0	131.5	172.6	176.8	185.4	178.0
FP1	18.5	25.2	87.6	73.4	66.9	111.7	79.2	56.5	59.9	78.1
(Equity)	(7.6)	(14.1)	(51.0)	(35.2)	(36.1)	(49.2)	(30.2)	(15.6)	(34.5)	(47.9)
(Bond)	(10.9)	(11.1)	(36.6)	(38.2)	(30.8)	(62.5)	(49.0)	(40.9)	(25.4)	(30.3)
Bank Lending	5.0	16.2	3.4	8.7	30.5	33.7	45.2	50.0	24.6	0.7

Source: World Bank, *Global Development Finance 2001*, Table 2.3.

Note: Long-term resource flows have a maturity of one year or more. Inflows of debt (bonds and bank lending) are net of amortization payments, and FDI is net of disinvestment. Figures for bond financing include sovereign, public, and private bond issues; the IMF calculates that in 1998-99 private bond issues accounted for about 31 per cent of the total.[11]

C. Balance-of-payments adjustment and trade

The expansion of trade depends on an appropriate mix of domestic macroeconomic management and foreign financing to prevent balance-of-payments disequilibria from spilling over into pressure on governments to apply restrictive trade or exchange policies. Adequate foreign financing for this purpose needs to be available from private capital markets and/or from international financial institutions such as the IMF, which is the case in normal circumstances. However, as noted above, large, frequent or unpredictable changes in foreign capital inflows and outflows that are not justified by underlying macroeconomic fundamentals can place pressure on the balance-of-payments, undercut sound domestic monetary and fiscal policies, and result in wide fluctuations in exchange rate policies. In such circumstances, recourse to private capital markets for balance-of-payments financing purposes may not be an option, and relying solely on official financial flows can create problems of moral hazard for international financial institutions. A government may then search for stop-gap solutions to its balance-of-payments problem, and turn to quantitative trade or exchange controls to restrict foreign exchange inflows and outflows. The extent to which the burden of adjustment to volatile inflows and outflows of foreign capital is placed entirely on a country's current account for a sustained period of time, domestic aggregate demand and trade will be affected.

On the other hand, trade liberalization may have a positive impact on the return of the balance-of-payment to equilibrium. As a result, trade reforms may be seen as "macro-relevant" as microeconomic measures can have a favourable impact on the sustainability of external accounts, which is a key macroeconomic variable (Box 1).

[11] *Ibid*, p. 53.

Box 1: The role of trade liberalization in restoring external viability

Trade liberalization supports the sustainability of the external account in different ways:

- Trade reform helps strengthen external viability by improving export competitiveness. Trade liberalization reduces the anti-export bias in domestic policies and promotes an open business environment that attracts foreign investment. The anti-export bias is reduced through the elimination of direct export controls (taxes and bans) and indirect impediments to competitiveness, such as high and distortionary import tariffs, or local-content requirement imposed on domestic producers. These controls and impediments raise production costs for exporters, or reduce their ability to obtain quality inputs at internationally competitive prices.

- Trade reform fosters long-term economic growth by improving the efficiency of resource allocation, hence contributing to balanced external accounts. Trade barriers tend to divert labour and capital from their most efficient use, by artificially increasing the rate of return on factors of production in protected sectors. This leads to a sub-optimal mix of production, investment and consumption, reducing the economy's growth potential. Trade reforms improve the efficiency of resource allocation by removing distortions and creating the proper incentives for economic activity.

- Trade reforms contributed to the integration of many developing and transition countries into the world economy. After the collapse of the Berlin wall, for example, most Eastern European transition economies engaged aggressively in trade liberalization, allowing for a change in the geographical direction of their trade, in favour of the European Union. As a result of these deep trade reforms, they have been able to sustain high rates of export growth over extended periods. Similar experiences can be found in Latin America, Asia or in the Middle-East.

- Trade liberalization also helps improve transparency and governance. Complex, discretionary trade regimes are breeding grounds for rent-seeking activities and corruption. Liberalization and simplification of the trade regime can only serve to reduce these activities, which tend to maintain high "fixed costs" on imports and frustrate the diversification of exports.

D. Changing global trade and financial environment

In the 1980s and 1990s, financial integration occurred on a global scale, with the deregulation of domestic financial markets, the liberalization of international capital flows, and financial and technological innovation (BIS, 1986). One feature of this was a large increase in private capital flows from developed to developing countries. The lending exposure of G-7 banks to developing countries stood at some US$1 trillion by mid-1998. This brought with it greater vulnerability in these countries to changes in sentiment by international investors, since market expectations play a key role in setting financial asset prices and directing financial flows (IMF, 1998).

Episodes of more intense financial instability are to some extent a corollary of financial deregulation and liberalization. The decisive factor for many emerging market economies in the 1990s was that the seeds of instability had been sown in the more sheltered and controlled financial environment that prevailed beforehand. Competition exposed bloated and rigid cost structures, poor management of risk, and ill-designed or non-existent prudential safety nets. In some cases it also exposed unsustainable monetary policies and public and foreign debt obligations. The resurgence of international financial crises in the 1990s, with its negative effects on GDP, poverty and social development in the affected countries, has at times revived fears of the kind of contagion that occurred in the 1930s, which originated in the financial sector and spread to the real economy. Fortunately this has not happened, and the WTO has played an important role in this respect by ensuring that its Members did not resort to restrictive trade policies to try to cushion the adverse effects of international financial instability on the real sectors of their economies (WTO, 1998). Nonetheless, a sense of vulnerability to instability in international financial markets and to sudden changes in market sentiment large enough to create systemic difficulties for trade and the trading system remains, particularly in emerging market economies.

A globalizing financial system can benefit the world economy through improved financial intermediation and a more efficient international allocation of savings and investment. These benefits accrue as much to international trade and investment as to other economic activities, so that financial integration is no enemy of trade integration. Trying to draw a line between "good" and "bad" forms of international capital flows is regarded as just as fruitless as attempts to distinguish between "good" and "bad" imports of goods and services. Instead, the lesson to be drawn is that if it is to function well, the international financial system needs to be based on strong prudential rules, effective surveillance, and transparency (Summers, Id, p. 3).

E. Causes and implications of financial crises, in particular for trade

There were several episodes of international financial crisis in the 1990s, affecting mainly emerging market economies. The first and largest, in terms of financial flows involved, occurred in 1992-93 within the European Monetary System. It was followed by crises involving Mexico (1995), South-East Asia, mainly Thailand, Indonesia and Korea (1997-98), Russia (1998) and Brazil (1998). Each had its own causes and characteristics, but to some extent the crises that occurred in 1997-98 reflected a general movement of international portfolio investment out of emerging market economies. In addition, the threat of contagion among borrowers created serious problems for some lenders, and together this took on proportions of international systemic crisis in the late-1990s.

1. Causes

There is a large body of literature on the causes and characteristics of these crises. It is generally acknowledged that capital account instability played a much more significant role than in the more traditional current account/balance-of-payments crises of the 1970s and 1980s, which were linked to uncontrolled spending, high inflation, and excessive public debt. However, there is no real consensus on the factors that triggered the crises in the 1990s, nor on appropriate policy responses (IMF, 2002b).

Financial sector fragility and inadequate banking supervision in the crisis-hit countries is considered by many analysts to have been one of the principal factors involved. In South-East Asia, for example, financial sector fragility involved unhedged, short-term, foreign borrowing by local financial institutions encouraged by the relative stability of nominal exchange rates, a mis-match in bank balance sheets between long-term assets and short-term liabilities, and imprudent lending and over-exposure in real estate and equity markets. This was combined with poor banking supervision, low capital requirements, and in some cases accommodative monetary policies and poor sequencing of capital account liberalization on the part of local monetary authorities. These processes are described by the IMF (Lane, 1999; Berg 1999) as well as UNCTAD, 2001.

In this context, the role of highly leveraged financial institutions, hedge funds and off-balance sheet operations of some institutional investors, and lack of prudential control over their activities, has been pointed at as a contributing factor.[12] "Herd" behaviour on the part of foreign capital is felt by many to explain why the retreat turned into a rout in some of the crisis-hit countries, where inadequate information, particularly about the level of foreign exchange reserves, made an objective evaluation of the situation more difficult (Summers, 1999). A number of analysts offered interpretations in terms of international liquidity crisis (Calvo, 1998; Sachs, 1998).

The merits and demerits of capital account liberalization in general, and its sequencing in particular, have been analysed, since most financial crises followed the liberalization of capital account transactions by the countries affected. Most European countries had completed this by 1990 as part of the single market project. As public debt and other domestic assets became traded internationally, large unhedged net capital inflows were recorded in France and Italy. A similar process was also observed in emerging markets. In this respect many consider that capital account liberalization in itself was not the problem, but that it had not been accompanied by upgrading prudential regulation and proper capitalization of

[12] A description of leverage strategies and hedge fund operations is provided in IMF (1998).

domestic financial institutions. Wyplosz (2001), for example, found that while liberalization reduces foreign exchange pressure in the long run, it can be a source of instability initially, particularly where credit growth is not kept under control.

Internal structural weaknesses outside the financial sector are viewed by many as having reduced the defences of the crisis-hit economies to external shocks. Trade policy reviews by the WTO suggested that trade liberalization and domestic deregulation had proceeded only selectively in at least some of the crisis-hit countries, leaving them with high and uneven levels of assistance across sectors and preventing market mechanisms from efficiently allocating resources. Part of the approach of the international financial institutions to resolving the crisis addressed these long-standing impediments to growth. This included, *inter alia*, promoting competition in the domestic economy, restructuring insolvent corporate and financial institutions, and addressing deficiencies in governance in various sectors of the economy. (A description of World Bank's role during the Asian crisis is available in section VII of IMF's Occasional Paper 178, Id.).

Related to this was deterioration in their terms of trade and erosion of their competitiveness. The Asian Development Bank noted that the Asian "dragons", encouraged by years of successful export-led industrial-targeting strategies, had invested massively throughout the 1990s in capacity in highly cyclical manufacturing industries such as electronics, semi-conductors and steel. The fall of international demand and prices for these products in 1996 led to a deterioration in their terms of trade, and as a result of the export downturn investors diverted investment into less efficient and more speculative activities (Kumar and Debroy, 1999). There is no clear evidence of similar factors at play in Mexico, East Asian countries, or Brazil (Kumar and Debroy, id., p. 10-11).

While most analysts agree that macroeconomic imbalances was not the main factor behind the crisis in South East Asia, the contribution of fiscal and monetary policies and current account positions before the crisis broke out has been debated (Kumar et. al. 1999; see also Stiglitz, 2002). Most of the Asian countries involved had budget surpluses, high savings rates, reasonably low inflation, and real exchange rates that did not appear to be out of line with fundamentals (Lane, 1999). However, Summers points to concerns of international investors, as the crisis deepened, about the viability of exchange rates in most cases, the possibility of a devaluation-inflation spiral in some, the fiscal deficit in Russia and Brazil, and current account deficits in Asia (Summers, 1999). The IMF and World Bank also point out that financial sector fragility had built up on weakening macroeconomic conditions in the year or two before the crisis broke (Lane et. al., 1999; IMF 2002b; World Bank, 1999). Nonetheless, "although concerns over the sustainability of current account deficits and exchange rate pegs played a role, they do not explain the suddenness and magnitude in the shift of the capital account" (IMF, 2002b).

2. Implications

Following growth rates of 5 to 10 per cent a year from 1994 and 1997, GDP contracted by the same magnitude in Indonesia, Malaysia, South Korea, the Philippines and Thailand in 1998, along with rising unemployment and inflation, and in some cases, social dislocation. Summers (1999) notes that large swings in exchange rates exacerbated the fundamental weaknesses described above (financial fragility, external vulnerability, poor governance). Real depreciations in exchange rates, estimated at between 20 and 40 per cent for ASEAN-5 countries from mid-1997 to mid-1998, reduced real incomes and spending, increased capital outflows and created the conditions for a banking crisis as the domestic currency value of foreign liabilities multiplied. (Impact of the East Asian Financial Crisis on Trade and of Industrial and Emerging Market Economies, 1998). This created a vicious circle: the depreciation of currencies brought more institutions into insolvency, further weakening confidence and fuelling more capital flight (Lane, 1999). In the affected countries, a long process of bank and corporate restructuring began, involving the re-capitalization of banks, enhancement of prudential rules, mergers and acquisitions, bank closures, and negotiations with international creditors to re-schedule short-term debt.

One factor that affected trade of the crisis-hit countries adversely was the scarcity of short-term trade-financing facilities (letters-of-credit) (WTO, 1999 and 2003;[13] IMF, 1998 and 2003;[14] and Stephens, 1998).[15] Financing imports became a particular problem at the peak of the crisis in Indonesia, where international banks reportedly refused to underwrite letters-of-credit opened by local banks because of a general loss of confidence in the local banking system. Given the high import content of exports (over 40 per cent), Indonesia's growth of exports was seriously affected by the difficulty of financing imported inputs for use in its export sectors. To alleviate the problem, the Indonesian Government and Central Bank extended guarantees to foreign banks for letters-of-credit opened by Indonesian banks, and encouraged the Steering Committee of private borrowers and lenders to find an arrangement to maintain trade finance facilities and settle arrears.[16] In the wake of the crisis, ASEAN Members agreed on the principle of reducing their dependence on the U.S. dollar as a currency of payment and promoting the use of local currencies in intra-regional trade (WTO, 2004 and 1998, Trade Policy Review of Indonesia).

The contraction of trade flows in 1998, particularly imports, in most emerging market economies led to a short-lived reduction in world trade, although this was limited by sustained strong import growth in the United States and the European Union (WTO, International Trade Statistics and Annual Reports; and OECD, 1998). There was a consequent shift away from intra-regional trade, but the export boom from currency depreciations in the crisis-hit countries that was anticipated did not materialize in the short-run. Van Rijckenghem et. al. (1999) concluded that financial market spill-overs (whereby banks sell off assets in one country to make up for losses in another) played a far larger role in these crises than trade spill-overs.[17]

F. THE ROLE OF TRADE POLICY IN RESPONDING TO OR PREVENTING FINANCIAL CRISIS

1. Keeping markets open and preventing the spread of financial crisis through trade channels

The value of a strong multilateral trading system was made evident during the South-East Asian crisis. Fears that the financial crisis would provoke a trade protectionist backlash, either in the crisis-hit countries and/or in their major trading partners, proved to be largely unfounded.

Aside from a few tariff increases in Thailand and Malaysia, the crisis-hit countries themselves did not view trade restriction as a useful solution to their immediate problems. The WTO contributed to this outcome and to the return of confidence and recovery, as countries continued to phase-in their Uruguay Round commitments and to undertake new multilateral liberalization initiatives (WTO, Annual Report, Chapter III "Overview of Developments in the International Trade Environment" 1998, 1999 and 2000 and OECD id, p. 11-13). At the height of the financial crisis, in December 1997, the WTO concluded the Agreement on Financial Services (5th Protocol to the GATS) and significant progress was made in enhancing financial services market access. In doing so, WTO Members gave a clear indication that increased foreign competition helped strengthen domestic financial sectors, by encouraging efficiency in the provision of financial services, promoting institutional development and improving financial regulation (WTO 1999).

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[13] M. Auboin and Ewert-Meier, M. (2003), "Improving the Availability of Trade Finance During Financial Crises", WTO Discussion Paper no.2, December, Geneva.

[14] IMF (2003), Trade Finance in Financial Crisis: An Assessment of Key Issues".

[15] M. Stephens explains the mechanisms by which trade finance, or the lack of it, has been perceived as an important problem in South East Asia. Its main conclusions are that the export credit agencies in no sense or prolonged the reduction in trade finance, but neither have they helped solve the problem.

[16] For details, see in particular WTO (1998), Trade Policy Review of Indonesia, p. 10 and p. 77, and World Bank (1998).

[17] Spillovers through trade links exist essentially at bilateral or regional level; with high levels of bilateral trade, a financial crisis will negatively affect all other trading partners through loss of competitiveness or fall in demand.

Exports from the crisis-hit countries of sensitive products (e.g., steel, semi-conductors, electronics) increased, stimulated by their excess capacity and depreciating exchange rates, but not by as much as had been anticipated by some. By and large, their exports were not met with a tightening of restrictions abroad, although there was evidence of increased import surveillance in some of their major trading partners, particularly for alleged dumping.

2. Trade policy reforms to improve efficiency and resilience to external shocks

As noted above, WTO Trade Policy Reviews of some of the crisis-hit countries described how selective processes of trade and investment liberalization had created "dual" economies, of sectors and industries that were outward-oriented and highly competitive internationally alongside others that were supported by complex mixtures of trade restrictions, implicit and explicit subsidies, and internal restrictions on competition. For example, the recent Trade Policy Reviews of Indonesia (WTO, 1998 and 2004) described how internal and external policies had consolidated the position of large public and private conglomerates, whose expansion had been fuelled by the absence of clear competition rules and tolerance of internal and external marketing arrangements and cartels. These conglomerates benefited from tax incentives, subsidized lending, procurement awards and other forms of assistance, often in return for their implementation of industrial policy objectives. While this contributed to the diversification of production, it also resulted in the concentration of production and private debt in the hands of a few business groups. In this sense, misallocation of resources in the real sector went hand-in-hand with misallocation in the money/credit markets.

In the context of their programmes with the IMF and the World Bank, several crisis-hit countries opened their trade regime further, as part of an effort to improve efficient resource allocation, eliminate the anti-export bias that is inherent to restrictive import regimes, and remove internal and external obstacles to growth.

The experience described above points to the role of the WTO as a "shock absorber", making its Member countries' economies more resilient to external shocks by providing security and predictability of trading conditions in periods of strain for the world economy. It points also to the role that domestic trade policy reform can play in individual countries. A liberal trade policy can make a major contribution to strengthening a country's balance-of-payments situation by improving its export competitiveness. Trade reform promotes an open business environment that attracts foreign direct investment. It fosters stronger long-term economic growth by improving the efficiency of resource allocation. It helps improve transparency and governance. In the specific case of financial services, trade liberalization within a sensible prudential framework can help prevent crises from occurring. A more competitive environment for the supply of financial services generates a more efficient allocation of savings and credit, reduces transactions costs and spreads, disseminates modern managerial and banking practices and promotes the use of internationally-accepted standards and codes, and helps to reduce risk. It can also help deal with financial crisis when it occurs. In many crisis-hit countries, foreign institutions contributed to the re-capitalization and restructuring of ailing local banking sectors.

G. STRENGTHENING THE FINANCIAL ARCHITECTURE

The financial crises of the 1990s raised important challenges for the international financial system. These are being tackled through work on crisis prevention, in particular by fostering transparency of financial policies, enhancing financial supervision, improving surveillance of the financial system at the individual country level, and increasing the availability of key data for vulnerability and sensitivity analysis.

1. Transparency and financial supervision

Improved transparency by increasing the flow and accuracy of information that is available to the private sector and to policymakers aims to strengthen the discipline exerted by markets (Eichengreen, 1999). It involves enhanced surveillance by the IMF of capital markets and national economic policies, and greater effort to make this information available to the public. Greater access to information on the flow of credit to emerging markets can provide an early indication of an excessive concentration of debt, and together with more accurate assessments of economic risk this can lead to more prudent behaviour on the part of lenders. Improved information enhances microeconomic efficiency, but it may not do much to improve macroeconomic stability, which is dominated by the evolution of opinions and expectations rather than information (Ocampo, 2001, p. 7).

Adopting and disseminating international standards and codes of good practice on prudential supervision, and encouraging their use, particularly by emerging market economies, has become the principal instrument of crisis-prevention (Kenen, 2001). The Financial Stability Forum, established to strengthen cooperation amongst the international groups involved in financial regulation and oversight, has identified twelve standards and codes as being of key importance for sound financial systems.[18] The best known, the SDDS, sets standards for the publication of economic and financial data. Internationally accepted standards contribute to an environment conducive to investment and trade in goods and services, and the scope for their use as regulatory disciplines in services trade is contained in the GATS. The Capital Markets Consultative Group, convened under the aegis of the IMF, is designed to foster public-private sector cooperation to operationalize crisis prevention measures. The view among Fund Members on standards has shifted dramatically and a growing number of participants in the major financial centres are increasingly relying on standards assessment to inform credit and investment decisions (IMF, 2001).

2. Strengthening financial systems and identifying vulnerability

One of the main aims of the financial architecture exercise is to reduce the gap between the fast pace of financial liberalization by emerging market economies and the slow pace of financial sector reform (Kenen, 2001, 93). Building institutional capacity in emerging market economies to improve bank supervision and strengthen the banking sector is a long-term process. In 1999, the IMF and the World Bank introduced the Financial Sector Assessment Programme, which provides comprehensive analysis of Members' financial sectors and can contribute to assessing their readiness to benefit from liberalizing their financial sectors. Under this voluntary programme, experts assess, on a confidential basis, a country's compliance with key standards and codes to help identify problems and programme design. One of the lessons drawn from the financial crises of the 1990s is that a country's vulnerability to the withdrawal of capital could have been reduced by better knowledge and management of its foreign asset and liability positions (IMF, 2001). Considerable effort has gone into discussing what is an adequate level of reserves and how best to disclose adequate information to markets. The availability of capital flows to offset current account shocks should, on the face of it, reduce the amount of reserves needed. But access to capital is uncertain and inflows are subject to rapid reversals.

Empirical tests confirm that the ratio of short-term external debt to reserves is the indicator best correlated with the incidence of foreign exchange crises, and that holding reserves in excess of short-term debt reduces the depth of crisis in emerging markets during periods of contagion.[19] For countries with limited access to private capital, reserves must be sufficient to absorb and smooth shocks of declining exports or increasing import prices.[20] While there is a strong case for emerging market economies to accumulate adequate reserves, there are also costs involved, and dangers to be avoided; accumulating excessive reserves can lead to lax macroeconomic policies as the external constraint is effectively relaxed (IMF, 2001, p. 28). A recent review by IMF staff members of early warning indicators nevertheless provide mixed results in terms of their efficiency. Although they seem to be statistically a good predictor of crisis, it is less clear whether they are useful to an already informed-observer. (IMF, 2004).[21]

[18] Included are the IMF's Special (or General) Data Dissemination Standard, the Code of Good Practices in Monetary and Financial Policies and the Code of Good Practices on Fiscal Transparency; the BIS's Core Principles for Effective Banking Supervision and the Financial Action Task Force's Forty Recommendations of the FATF. See: <www.fsforum.org>.

[19] Emerging market economies have raised their reserve holdings markedly in recent years. The ratio of reserves to short-term debt has risen from 100 per cent at end-1997 to 180 per cent at end-2000.

[20] Opening remarks by Stanley Fischer, IMF/World Bank International Reserves: Policy Issues Forum, Washington, D.C. April 28, 2001.

[21] Assessing Early Warning Systems: How Have They Worked in Practice? IMF Staff Paper WP/04/52, Andrew Berg, E. Borenszein, C. Patillo.

H. Financial liberalization and financial stability

Lack of financial reform contributes to macroeconomic and banking sector weakness (Dobson and Jacquet, 1997). It can unwittingly provide incentives for policy makers to adopt bad macroeconomic policies, while restrictions create an illusion on the part of the authorities that they are immune to financial instability and thus pursue unsustainable policies (Wyplosz, 2001). The transition to a liberal, market-based financial system involves difficult and costly institution-building (Wyplosz, 2001) recognizes the short-term costs of opening up the financial sector (see e.g., Williamson and Mahar, 1998; Steinherr and Perée, 1999). Sequencing liberalization properly, in line with the building of adequate prudential structure and supervision, has been subject to many studies. Posen suggests that emerging markets and even developed small open economies should import financial services; not only does foreign direct investment in the financial sector ensure the transfer of skills, technology and management techniques but it allows a small economy to benefit from more diversified portfolios and better supervision (Posen, IIE, 2001).

The WTO's General Agreement on Trade in Services (GATS) implicitly acknowledges that there is no universally acceptable liberalization strategy and that a country must determine the specific timing or sequencing of its financial reform in line with its individual circumstances. Liberalization can, in an inadequate policy environment, exacerbate the potential effects of shocks but it also improves the ability to absorb them. While initially a potential source of exchange rate instability, in the long-run financial and capital account liberalization helps stabilize the exchange rate. Trade in financial services can also reduce the systemic risk for small financial markets that are less able to absorb large shocks. Vulnerability to terms-of-trade shocks or international interest and exchange rate pressures cannot be avoided by attempting to insulate the financial sector from trade. Interest and exchange rate fluctuations can be hedged better in an open international environment. A liberal trade regime allowing for capital flows can ease short-term balance-of-payments pressures (WTO, 1997). However, as a crisis prevention strategy it is essential that governments adopt coherent policies between financial sector reform and market-access commitments. The WTO Agreement on Financial Services leaves some leeway to Members to take home country measures to protect the soundness and safety of the system, although they should not be used so as to restrict competition. To the extent that trade liberalization stimulates capital inflows, the reversal of such capital flows in a period of loss of confidence can worsen the situation of financial institutions and, thereby, magnify the adverse effects of poor macroeconomic and regulatory policies.

Financial services trade liberalization and capital account liberalization are two distinct issues but they are closely linked. Properly balanced and sequenced capital account liberalization is the only way to achieve maximum protection from financial crisis. Some general principles which are helpful in sequencing and coordinating capital account liberalization with structural policies to strengthen domestic financial systems have been developed (see also e.g., IMF, 2002; Islam, 2000; and Dailami, 1999). These include taking account of the initial condition of financial and non-financial entities and their capacity to manage the risks associated with international capital flows; assessing the effectiveness of capital controls; identifying and implementing urgent measures in connection with reforms which require a long lead time; and ensuring the sustainability of the reforms and the transparency of the liberalization process. In most cases, it is desirable to liberalize long-term flows, especially foreign direct investment flows, before short-term flows (see in particular Chapter IV of IMF, 2002).

Emerging market economies will need time to upgrade their financial systems, and therefore should be encouraged to adopt interim measures that will insulate their financial systems from the intrinsic volatility of international capital flows (Kenen, 2001). The case for temporary capital controls in crisis prevention and resolution has been made by a variety of analysts (see e.g., Johnston and Tamirisa, 1998; Cooper, 1999). The IMF states that "it appears that in the absence of adequate macroeconomic and financial policies, capital account liberalization may increase vulnerability to external and domestic shocks" (IMF, 2000). The Financial Stability Forum suggested that "capital controls could be considered if they have a prudential element and fit into a risk management framework". Others have posited the need for "Chilean-type capital inflow taxes as the only effective solution for most developing countries with an open capital account but where risk management is inadequate and supervision and regulation less than effective" (Eichengreen, 1999). Others consider that without effective prudential banking regulations, restrictions on capital inflows are unlikely to reduce a country's vulnerability (Edwards, 1999). The debate on capital controls should take into account the lesson learned from experience with international trade policy. If certain types of capital flows are considered "hazardous", tariff-like protection is more desirable than quantitative restrictions or prohibitions (Schuknecht, 1999).

III. THE RELATIONSHIP BETWEEN TRADE AND DEBT, AND THE ROLE OF THE WTO

External debt is a major issue confronting developing countries and emerging market economies and it has an impact on their capacity to reap the benefits of their participation in the multilateral trading system. This is recognised by G8 leaders (2002), as well as the Breton-Woods Institutions and the WTO, when emphasizing complementarity between initiatives to reduce indebtedness and to improve market access for poor countries.[22] From an analytical perspective the link between trade and debt appears less straightforward than that between trade and finance, or at least less direct. Debt is only one of several instruments of external financing, along with foreign direct investment and portfolio equity investment. Economic theory suggests that reasonable levels of foreign borrowing are likely to enhance growth, particularly in countries at an early stage of development which have low savings rates and small stocks of capital, and that in these countries investment returns are likely to be higher than in more advanced economies. Clearly, it is important that borrowed funds should be used for productive investment that generates a return – and economic growth – that is sufficient to cover debt repayment. Even where that is that case, however, a number of factors may still constrain countries' ability to repay their debt or to attract foreign capital for development. Some of these factors are examined below.

A. MARKET ACCESS AND FOREIGN DEBT

One relevant factor from the WTO's point of view is that overseas market access restrictions can impede the ability of indebted countries to earn the foreign exchange they need to service their external debt, and to avoid resorting to further unsustainable borrowing.[23] In the context of the launch of a new round in Doha, the WTO on the one hand, and the IMF and World Bank on the other, examined market access restrictions faced by developing countries.[24] Special attention was devoted to the situation of the LDCs and highly indebted-countries. The studies revealed that, while most other developing countries had shared in the growth of world trade in the past thirty years, the poorest countries saw their share of world trade divided by four; the LDCs' share of world trade fell from 1.9 per cent in 1970 per cent to some 0.4 per cent today. The studies pointed to the prevalence, in these countries' main trading partners, of market access barriers on their exports of agricultural and labour-intensive manufactured products (see section III.A for a more detailed description). The poorest countries comprise virtually all LDCs and highly-indebted countries eligible for relief under the IMF-World Bank Enhanced HIPC Initiative. Reversing the marginalization of these countries requires a broad-based strategy combining economic growth, stability, poverty reduction and debt relief – as outlined by the Poverty Reduction Strategy Paper (PRSP) process of the IMF and World Bank. Nonetheless, trade policy reform and improved market access for these countries' exports needs to be a central part of that strategy.

Other studies have concluded that the gains that can be derived from eliminating trade barriers on these countries' exports far outweigh annual flows of ODA and debt relief. One IMF study calls for a more coherent approach between trade and aid policies, whereby trade policies would create market access opportunities for developing countries, and concessional financing of development policies would enable them to build the capacity necessary to respond to these opportunities.[25] Key components of such an approach include: more generous and predictable market access, especially for the poorest countries; actions by industrialized countries to reform their agricultural policies; and open, outward-looking trade policies in developing countries themselves.

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[22] See in particular the last G8's Summit Chair's conclusions at <http://www.g8.utoronto.ca/g7/summit>.

[23] An elaboration of this link is available in WT/GC/W/356/Add.1.

[24] See WTO 2001(a) and IMF and World Bank 2001(a). An update of the IMF and World Bank paper, "Market Access for developing countries exports" was made available on the IMF and World Bank website in 2002.

[25] IMF 2002.

B. TRADE LIBERALIZATION AND DEBT

While lack of access to markets can be a major reason why developing countries may not be able to exploit their comparative advantage, lack of trade liberalization by these countries can also play an important role. Inward-looking, restrictive trade policies raise the cost of imports, and hence exports, and tend to divert labour and capital from their most efficient uses, thereby leading to a sub-optimal mix of production, investment and consumption.[26] The Monterrey International Conference on Financing for Development highlighted in its conclusions (the so-called "Monterrey Consensus") that "meaningful trade liberalization is an important element in the sustainable development strategy of a country".[27] All general equilibrium simulations indicate that the largest gains for a country from further liberalization of trade – from half to two-thirds of the total – accrue from the removal of its own trade restrictions. The removal of trade barriers by its trading partners are typically of lesser importance, although they may account for a significant share of total gains, particularly if the country is specialized in a particular sector, and this sector is subject to very restrictive market conditions. In principle, the largest gains stem in each country or region from liberalizing the most protected sectors.[28] Trade regimes in poor areas, in particular Africa, which remain more restrictive than in other parts of the world are likely to be the among the biggest beneficiaries of further trade liberalization, particularly multilateral liberalization which combines the liberalization of a country's own trade restrictions with the liberalization of those of its main trading partners.

At the world level, estimates of the gains from further liberalization of merchandise trade range from US$250-550 billion, one third to over half – depending on the specification of models – of which would accrue to developing countries. This is in any case well in excess of annual aid and debt relief flows, as noted above. Model calculations show that in nominal (absolute) terms, industrial countries reap the largest gains from liberalization (notably as a result of the elimination of their own barriers to agricultural trade), but because developing countries' economies are on average more protected than those of industrial countries in manufactured goods, they gain more from global trade liberalization as a percentage of their GDP. Gains from trade typically stem from increased income for domestic consumers and industrial users of imported inputs. Liberalizing trade restrictions can therefore have a positive impact on external debt and debt servicing, as it tends to boost domestic growth, productivity and exports. A study found that the level of openness to trade had positive effects on the debt structure of countries, by attracting foreign direct investment (a cheaper source of foreign capital than debt) and hence foreign exchange reserves, which in turn enabled countries to finance technology transfer and hence improve productivity, and to shift towards production with higher income-elasticity and better terms-of-trade.[29]

[26] UNCTAD 2001 (b).

[27] Paragraph 27 of the "Monterrey Consensus".

[28] Hertel 2000.

[29] Lane, Milesi-Ferretti, 2000.

C. TRADE BALANCE, BALANCE OF PAYMENTS AND EXTERNAL DEBT

The economic literature identifies other (direct or less direct) links through which debt, fiscal policy, the balance-of-payments and trade are intertwined.

- The impact of declining terms of trade: the problem of the structural decline in the terms-of-trade and its impact on commodity-dependent exporters, in particular their greater vulnerability to trade and current account imbalances and indebtedness, is recognized internationally. A paper by Birsdall and Hamoudi (2002) provides evidence that declining export prices affect fiscal and external accounts negatively, contribute to reduced public consumption and investment, and force private companies, due to lack of export receipts, to reduce imports of productive inputs, thereby preventing the diversification of local production. UNCTAD

(2001 (a) and 2003),[30] suggests that declining terms-of-trade in Sub-Saharan Africa have led in the past thirty years to a drying up of domestic investment resources. In addition, poor market access prospects or deterioration of the terms-of-trade are factors undermining a country's ability to access international markets on attractive terms. In practice, countries with a low level of development and of integration in world trade lack credibility in international capital markets, thereby failing to attract private capital flows and becoming reliant on external public debt. At such a level of development, the low level of both domestic savings and investment (respectively 15 per cent and 18 per cent in Sub-Saharan Africa) and continued mis-match between the two, calls for external public financing for an extended period of time.[31]

Countries having access to capital markets (in general middle-income developing countries) have become vulnerable to change in market sentiment and the increased costs of borrowing. In addition, large inflows of private capital have turned into outflows at times of changing market sentiment (such as during the Asian crisis), leading to major collateral damages on the financial system, trade, investment and employment. In a recent paper, Ajayi and Khan (2002) argue that such outflows, responsible for major drains on foreign exchange reserves, require governments to substitute for the private sector, and hence to borrow to match balance-of-payments gaps generated by private outflows. At the end of the crisis, government and private debt would have increased considerably, with negative spill-overs on international ratings and cost of debt.

- Trade, efficiency of the financial system and debt: in this vein, it has been argued that the expansion of trade depends on efficient sources of financing, which in turn requires an efficient, sound and well-managed domestic banking system. An important issue in this respect is balancing the advantages that can accrue from liberalizing trade in financial services with the need to ensure that liberalization is properly timed, sequenced and prudentially managed so that it does not become a source of financial instability in its own right. Another issue is the need to modernize domestic banking systems and government budget financing in low-income countries, in order to avoid resorting to foreign financing (Beaugrand, Loko, Mlachila, 2002). It has been argued that the absence of efforts in some low-income countries to create liquid markets for long-term, fixed interest government debt and the unavailability of adequate instruments to hedge against exchange rate risk led also to risky external borrowing (Mello, Hussein, 2001).

- The "fiscal channel" is key to the link between trade and debt. One aspect is the impact of trade liberalization on fiscal revenues, that some African countries regard as being negative. A study by Ebrill, Stotsky and Gropp (1999) indicates that well sequenced tariff reforms can be revenue-neutral (or in some successful cases, revenue-enhancing) if part of an overall fiscal reform, which would include, on the one hand, the offsetting of the negative effect on public finances of the lowering of average tariffs by the elimination of tariff peaks and of tariff exemptions, and on the other hand, the introduction of internal taxes (such as the value-added tax). Another aspect is the fiscal impact of deteriorating terms of trade. The lowering of export prices (generally expressed in dollars) does not necessarily lead to reduced incomes of local producers, whose prices are expressed in local currency. However, it may affect public finances, for example, in case of taxes levied on exports. On the other hand, the deterioration in the terms of trade may have a positive effect on public revenues if taxes drawn from the increase in import values outweigh fiscal effects of the reduction in export prices. Nonetheless, some authors make the case that during the Asian crisis the loss in the terms of trade due to the devaluation and its related domestic income effects had a

[30] UNCTAD (2003), Report of the Meeting of Eminent Persons on Commodities Issues, TD/B/50/11, September, Geneva.

[31] Paragraph 39 of the "Monterrey Consensus" states that "for many countries in Africa, least-developed countries, small island developing States and landlocked developing countries, ODA is still the largest source of external financing and is critical to the achievement of the development goals and targets of the Millennium Declaration and other internationally agreed development targets".

negative impact on government revenues (Hussain, Mlambo, Oshikoya, 2001). L.A. Winters (2000) further cautions that trade liberalization, when reducing government revenues, curtails expenditure on poverty and social policies, or forces governments to levy taxes on goods consumed by the poor. He advises governments to display care in liberalizing trade and suggests pro-poor expenditure that would offset the effects of liberalization. A third fiscal issue, is the fiscal impact of the cost of debt, which is addressed, for poor countries, in the context of the HIPC Initiative (section IV.B).

D. TRADE AND DEBT

1. WTO, market access and indebtedness

Initiatives to improve access of LDC's exports to industrial countries' markets are likely to result in significant benefits for these countries. The integration of developing countries in world trade is core to the mandate of the WTO. The terms of its preamble and the 145 Special and Differential Treatment provisions contained in the various WTO Agreements are testimony to it.[32] Still, soon after the end of the Uruguay Round, when it appeared that the least-developed countries continued to lose market share, the then Director-General of the WTO, called, at the Group of Seven Summit in Lyon in 1996, for exports from the poorest countries to be granted across-the-board, bound, duty-free, and quota-free access to industrial country markets, a proposal subsequently endorsed by the Managing Director of the IMF and the President of the World Bank.[33] Although multilateral negotiations were the best route for maximizing the economic effects of liberalization, the proposal was made on the grounds that gaining open access to industrial markets on a more permanent basis would significantly enhance trade incentives for Africa, and lead them to more active participation in future rounds.

In response to this call, several industrial and transition economies decided to grant LDCs similar treatment to that promoted by the Director-General (one the most significant being the "Everything but Arms Initiative" by the European Union), or improved preferences under their GSP system.[34] These measures, no doubt, constitute progress relative to existing unilateral trade preferences for developing countries (GSP, GSTP), which had been criticized in part because of their lack of transparency, permanency and complexity of rules of origin which limited their benefits and use. A paper by the World Bank measured the incidence of the recent initiatives to improve market access for the poorest countries that have been announced by the European Union, the United States, Japan and other countries on a sub-set of 37 Sub-Saharan African countries. It found that unrestricted access to the Quad's markets would produce substantial gains for the beneficiary countries, leading to a 14 per cent increase in non-oil exports (in the order of US$2.5 billion) and boosting real incomes by around 1 per cent, with negligible trade diversion costs for the rest of the world. Most of the gains would come from preferential access to the Japanese and European agricultural markets (Ianchovichina, E., A. Mattoo and M. Olarreaga, 2001).

However, while increased preferences for LDCs are a step in the right direction, all recent studies measuring the gains of a global, non-discriminatory reduction of trade barriers, in the context of a new multilateral round of negotiations, point to much larger gains for all countries, including developing countries. These calculations are based on the current patterns of protection in industrialized and developing countries:

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[32] The Preamble of the Marrakesh Agreement states: "Recognizing further that there is need for positive efforts designed to ensure that developing countries, and especially the least developed among them, secure a share in the growth of international trade commensurate with the needs of their economic development, […]".

[33] This endorsement is for example to be found in the tripartite Declaration of the Heads of the three agencies on the occasion of the third WTO Ministerial Conference.

[34] The Monterrey Consensus called on "developed countries that have not already do so to work towards the objective of duty-free and quota-free access for all least-developed countries, as envisaged in the Programme of Action for the Least Developed Countries adopted in Brussels".

- Developed countries, and Quad countries in particular, display much lower bound and applied average tariffs than developing countries, although tariff peaks exist in selected industries – for example, food and footwear in the European Union and Japan; and textiles and clothing, footwear, glass and electrical parts in the United States and Canada. While tariff escalation also exists for these countries, it is a common feature among other WTO Members as well, including developing countries, in relatively similar categories of products. Therefore, contrary to common belief, there is ample scope for further liberalization in industrial products (details in WTO, 2001 (b), p.27-31).

- For developed countries, the average bound and applied rates for agricultural products are four to nine times higher than that on industrial products (depending on countries and on methodology used), and for developing countries the average is two to three times higher than that for industrial products (WTO, 2001 (b), op. cit. p.30; and IMF and World Bank, 2001 (a), p.18).

Subsequently, and keeping in mind that countries benefit most from liberalizing sectors for which they have higher trade barriers, in nominal terms developed countries would gain more from the elimination of trade barriers, but in terms of GDP, developing countries' gains could be as much as two and half times as for the industrial countries (Hertel (2000)). Developing countries would in principle gain more from the liberalization of the manufacturing sector, while developed countries benefit most from agricultural liberalization. However, looking at Hertel's calculation, which are broadly similar results to those published by the Government of Australia, developing countries would account for 46 per cent of total trade liberalization across both agriculture and manufacturing, and developed countries taking up the remaining 54 per cent. Looking at more detailed calculations (Anderson, 2000), LDCs would gain most from agricultural liberalization in developed countries because of the greater relative importance of agriculture in their economies, while higher income developing countries gain most from liberalization in industrial products because of the greater importance of manufacturing in their GDP and exports. In any calculation, income gains generated by total liberalization of trade barriers would by far outweigh total savings from the HIPC Initiative.

2. Domestic policies must be supportive of trade integration and debt relief efforts

Outward-oriented trade policies at country level help to maximize the gains of an international open trading environment. However, special attention should be paid to the proper phasing and sequencing of trade liberalization to prevent an unequal distribution of benefits. According to Reimer (2002), while total effects of liberalization are positive economy-wise, the distribution of additional income among household groups may be uneven due to the reallocation of resources and factors of production triggered by the process of liberalization. Bannister and Thugge (2001) conclude in their study that the larger the number of sectors liberalized, the more individual groups will perceive the benefits of such liberalization and the more the cost of liberalization will be spread among sectors, age and gender groups. Although trade liberalization raises the average standard of living in the medium-term, groups that have been favoured by protection will see their income decline temporarily, and the resulting restructuring of the economy may create economic dislocations in the short-term.

Table 2: Benefits from Post-Uruguay Round Liberalization, 2005

	Benefits from		
	Agriculture	**Manufacturing**	**Total ($ billions)**
Developing countries	44	90	134
Industrial countries	120	40	160
Total	164	130	294

Source: Hertel, Thomas (2000), "Potential gains from reducing trade barriers", Federal Reserve Bank of Saint-Louis Economic Review, July/August 2000.

Trade policies should be supported by policies aimed at raising domestic private savings and foreign direct investment. Standard economic theory teaches that in the absence of full mobility of factors of production (such as land, labour and capital) countries will obtain these factors by exchanging goods intensive in the factors in which they are well endowed, against goods intensive in scarce factors (countries well endowed in labour would exchange labour-intensive goods against capital intensive goods) (Hecksher;[35] Ohlin). As seen above, obstacles to this process are the lack of market access and/or deteriorating terms of trade for labour-intensive goods exporters, creating external imbalances preventing the acquisition of imported capital goods. Another condition is that trade policy can be supported by policies aimed at mobilizing private and international savings, notably in the form of foreign direct investment. The importance of foreign direct investment in indebted countries is emphasized in the literature and in policy conferences on development, such as in the conclusions of the recent conference on financing for development held in Monterrey.[36] FDI is a stable form of capital relative to other forms of financing, has positive spill-overs on the technical development of host countries, and does not involve capital or interest repayments. A recent study by Lehmann, (2002), emphasizes that the positive impact of FDI on the balance of payments of developing countries and on capital formation, is not so much explained by the amount of the initial investment, but because of re-invested earnings (on average three quarters of investment incomes are reinvested in the host country).

The mobilization of private savings in LDCs is problematic in many ways, because of poor macroeconomic management (inflation, crowding-out of private investment), unsound banking sectors and lack of perceived investment opportunities in the LDCs. Ajayi and Khan (2002) examined, from the point of view of investors, the risk of investing into the local economy by residents. They found that LDC nationals often prefer to invest their assets abroad where risks are perceived as negligible, whereas assets invested in the national economy are regarded as more risky because they are prone to nationalization, taxation or expropriation. Other factors such as inflation, large fiscal deficits, fraudulent trade invoicing, lack of domestic credits and unfavourable terms of trade are found to be the main factors discouraging the investment of private savings into domestic investment. According to the authors, lack of private savings, inefficient financial intermediation and crowding out from fiscal deficits explain the unavailability or high cost of credit for small and medium size enterprises. Trade liberalization and fiscal policies must also play their part in the mobilization of savings. According to Go and Mitra (1998), trade liberalization may have, in the first instance, a negative effect on public revenues and public savings. However, as imports are also inputs in the production process, a tariff reduction has a favourable effect on output, private sector income, and hence private savings. But since just a fraction of the private sector finds its way to private savings, the increase in the latter does not completely offset the decline in public savings. Restoration in the savings-investment balance requires an increase in domestic savings, which can come either through an increase in the average tax rates or a reduction in government consumption. Depreciation of the real exchange rate also helps to restore the internal balance by boosting exports. Availability of external financing reduces the need for fiscal adjustment to make up for the shortfall in domestic savings arising out of tariff reduction.

[35] See in particular Hecksher, E. (1919), The Effect of Foreign Trade on the Distribution of Income, Ekonomisk Tidskriff, 497-512 translated in chapter 13 of American Economic Association's Readings in the Theory on International Trade, Philadelphia: Blakiston, 1949, 272-300.

[36] In paragraph 20 of the "Monterrey Consensus", it is said that "private international capital flows, particularly foreign direct investment, along with international financial stability, are vital complements to national and international development efforts. Foreign direct investment contributes toward financing sustained economic growth in the long term […]. A central challenge, therefore, is to create the necessary domestic and international conditions to facilitate direct investment flows [...] to developing countries, particularly Africa and least developed countries […]. Paragraph 21 emphasizes the need for countries to achieve a transparent, stable and predictable investment climate, while paragraph 22 calls on relevant international and regional institutions to increase their support for private investment in priority areas.

E. DEBT AND TRADE

1. Debt as a burden to the economy

A major concern is that high levels of external indebtedness reduce the capacity of developing countries to take full advantage of improved export market access opportunities because of insufficient new investment in productive capacity in their economies, particularly in their export sectors. The fact of being labelled as "indebted" deters new investors, while debt service obligations absorb available capital and foreign exchange to pay for imports. Some of these concerns are supported by empirical evidence found in the literature. In a recent paper Pattillo, Poirson and Ricci (2002), address the question of why large levels of accumulated debt lead to lower growth and under which conditions. They test the "debt overhang" theory, discussed above, which shows that if there is some likelihood in the future that debt will be larger than the country's ability to repay then expected debt-service costs will discourage further domestic and foreign investment and thus harm growth. Potential investors will fear that the more a country produces, the more it will be "taxed" by creditors to service the external debt, and thus they will be less willing to incur costs today for the sake of increased output in the future. On this basis, the authors drew a "Laffer" curve for debt, which posits that large debt stocks tend to be associated with lower probabilities of debt repayment. It appears from calculations held on 100 countries that the overall contribution of debt to growth appears to become negative at 160-170 per cent of exports and 35-40 per cent of GDP, while emphasizing that reasonable levels of debt (much below those levels) have a positive impact on growth.

While this paper emphasizes the "investment channel" as eroding growth and diversification of exports, the "external debt trap" may also work its way through the external sector, by maintaining a high level of vulnerability to balance-of-payments shocks. The mechanisms described by Beugrand, Loko and Mlachila (2002), associate high debt, responses to external shocks through currency depreciation or further borrowing, which in turn lead to an increase in the cost of existing debt expressed in local currency, with possible implication on the stability of local financial intermediaries.

Measures to address supply-side constraints of developing countries are at the centre of concerns of the international community. In its section on international trade, the "Monterrey Consensus" (paragraph 36) clearly invites multilateral, bilateral financial and development institutions to "expand and coordinate their efforts, with increased resources, for gradually removing supply-side constraints (of developing countries)". Members of the Conference emphasized the need to, *inter alia*, improve trade infrastructures, diversify export capacity and support the technological content of exports; and strengthen infrastructural development and enhance overall productivity and competitiveness. To that end, the "Consensus" calls on relevant institutions, including the WTO, to reinforce support for trade-related training, capacity and institution building, and trade supporting services. In a recent paper, the WTO – in line with paragraph 43 of the Doha Ministerial Declaration – describes some of the LDCs supply-side constraints that are relevant to trade and how the WTO is working with other partner institutions to meet this challenge (participation to the DDA round, technical assistance on WTO specific-matters, participation to the integrated framework, coherence work with other institutions, etc.).[37]

F. DEBT RELIEF, POVERTY REDUCTION AND TRADE

After a succession of debt crises in middle- and low-income countries in the 1980s and 1990s, international creditors launched several debt restructuring and relief initiatives or mechanisms, under the auspices of the Paris Club for bilateral ODA debt, the London Club for private debt, or international financial institutions for multilateral debt (the HIPC Initiative). The HIPC (Highly Indebted Poor Countries) Initiative represents a framework designed by the IMF and the World Bank, along with other multilateral creditors, to provide special assistance for heavily indebted poor countries that pursue IMF and World Bank-supported programs to reduce the external debt burden to more sustainable levels and strengthen the links between debt relief and poverty reduction policies (see IMF and World Bank, 2002). A first version of the HIPC Initiative was introduced in

[37] WTO Document WT/COMTD/LDC/W/33 of 26 May 2004.

1996, and an Enhanced Initiative, aimed at providing deeper and faster relief to a large number of countries, was introduced in 1999. To be considered for the HIPC Initiative, a country must meet a set of criteria: facing an unsustainable level of debt; after application of existing "traditional" debt relief mechanisms (Paris Club for example); having a good record in implementing IMF and World Bank supported programs; and adopting Poverty Reduction Strategies (PRSP) through a broad-based participatory process involving civil society in the beneficiary country. Thanks to PRSP, debt relief is fully integrated in a broad strategy to combat poverty that also involves integration through trade and trade liberalization.

The Enhanced HIPC Initiative results in significant reductions in debt stocks and service. According to a recent report by the World Bank (2002), the stock of external debt of the first 26 eligible countries will fall from US$62 billion to US$27 billion before and after relief in net present value terms, that is, from 60 per cent to 24 per cent of GDP (or 10 percentage points lower than the average of developing countries); debt service will decline immediately from one third to half depending on the country. Some authors point to the positive impact of debt relief on development. While savings from HIPC relief must be allocated to social and poverty reduction-related spending, such as health, education, the high standards required by the IMF and World Bank in the areas of macroeconomic management, good governance, public spending planning and poverty reduction, are likely to promote growth and improve the private investors' perception of the country risk in the eligible countries (Botchwey, 2000). One difficult point is that the decline in the terms of trade, e.g. resulting from a decline in export prices, tends to frustrate the intent of the HIPC Initiative by re-increasing the debt to export ratio by the time countries reach the "graduation" (completion) point.

IV. TOWARDS GREATER COHERENCE IN NATIONAL AND INTERNATIONAL POLICIES

A. OVERVIEW OF COHERENCE ISSUES

As set out in their respective mandates – the WTO Agreements and the Articles of Agreement of the IMF and the World Bank – all three organizations share the complementary objectives of facilitating the expansion and balanced growth of international trade, raising living standards, supporting sustainable development and developing cooperative policies. Activities carried out under the Coherence mandate therefore start from a solid systemic foundation. There are, nonetheless, significant conceptual and practical challenges involved for all three organizations in achieving harmony at the international level in the interaction between structural, macroeconomic, trade, financial and development aspects of economic policy-making. Account needs to be taken of the fact that there is no single, one-size-fits-all approach to policy-making at the national level. Account also needs to be taken of the fact that international economic integration of markets and countries ("globalization") is a dynamic process, so that the challenge of creating a coherent policy mix changes over time. This has to be factored into multilateral frameworks of policy rules (the WTO and IMF Agreements) and guidance (e.g., the World Bank's Comprehensive Development Framework, and the IMF/World Bank Poverty Reduction Strategy process), particularly if the Coherence exercise is to achieve its aim of increasing the effectiveness of policies at the national level.

Account needs also to be taken of the fact, reflected in the Marrakesh Ministerial Declaration on Coherence, that each organization operates according to its own mandate, yet the task of achieving greater policy coherence is, by its very nature, one that very often crosses the lines of individual organizational responsibility. Some of the challenges of enhancing coherence can be dealt with through routine cooperation between the WTO, IMF and World Bank at the staff level under the existing cooperation agreements – an example is cooperation with individual Member countries to organize the appropriate timing and sequencing of technical assistance and capacity-building in support of elements of the Doha Ministerial Declaration. Others can raise matters of a more systemic nature, which require the involvement and consideration of Members.

1. Trade and development policies

As emphasized on many occasions during the discussions of the Working Group on Trade, Debt and Finance since 2002, the relationship between trade, debt and finance and other global economic parameters has to be seen in a holistic manner embedded in the issue of how to mobilize development finances and resources for development. The issue of finance and debt can no longer be seen in isolation in the light of trade policies pursued by developed and developing countries. In this respect, the Group made clear that issues of market access, decline in commodity prices and debt relief needed to be taken into account in a coordinated manner, from a Coherence point of view. This "holistic approach" to international problems is in the spirit of the Monterrey Consensus, which in its paragraph 8, mentions that "in the increasingly globalizing world economy, a holistic approach to the inter-connected national, international and systemic challenges of financing for development... in all parts of the globe is essential". It also states "that international trade is an engine for international development, and that a universal, rules-based, open, non-discriminatory and equitable multilateral trading system can substantially stimulate development world-wide, benefiting countries at all stages of development".[38] In the following paragraph of the consensus, it is also highlighted that "meaningful trade liberalization is an important element in the sustainable development strategy of a country".[39]

The introduction of the joint IMF/World Bank Poverty Reduction Strategy process (PRSP) was already a recognition that only a consistent mix of macroeconomic policies, structural reforms, anti-poverty measures, and even debt relief, defined in the context of a participatory process involving civil society and greater country ownership, would allow the outcomes of the Fund and Bank programmes in low-income countries to be pro-poor. The PRSP

[38] Paragraph 26 of the Monterrey Consensus.

[39] Paragraph 27 of the Monterrey Consensus.

provided the WTO with the opportunity to encourage the World Bank to "mainstream" trade issues into its work, as recalled in the tripartite Statement issued in Seattle and in the April Development Committee communiqué. While mainstreaming trade into the PRSP has been a slow process to date, the renewed focus of the World Bank toward trade issues is welcome. The importance of the World Bank's support in this area is not only the financing they can help mobilize, but also their country-level involvement and policy expertise.[40]

The complementarity of trade and development is a natural basis for enhanced cooperation between the WTO and the World Bank (as well as other agencies active in development-oriented issues). The WTO fully supports the "Monterrey Consensus", and, as indicated above, to ensure that trade works for growth and development, policy and trade priority areas need to be anchored in the overall national development plans and strategies of poverty reduction. In the absence of this, trade cannot work for development. So far, the Integration Framework (IF) has been the principal mechanism in the international community for mainstreaming (integrating) trade into development plans and strategies for poverty reduction. The current challenge in the IF process is with implementation and follow-up to the results of the diagnostic trade integration studies. So far modest success has been achieved.[41] The Director-General of the WTO and the President of the World Bank recently announced that they would produce joint regular reviews of the IF.

Effective trade mainstreaming is linked to the ability of countries and international institutions to address the "behind-the-border" agenda. For example, in building-up the trade potential and infrastructures of developing countries through customs reform, improving transportation and distribution networks, easing access to trade finance, and improving export marketing. It also depends on developing and sustaining a domestic trade policy set within the overall development policy of the country. Furthermore, the efforts of agencies, donors, and the LDCs in mainstreaming trade to the benefit of the LDCs, need to be linked to effective movements in market access to enable the LDCs to take advantage of appropriate supply-side responses that will be stimulated through trade mainstreaming. Improvements in market access, therefore, remain indispensable. As indicated in his recent speech,[42] the Director-General of the WTO has set the broad objectives of the Integrated Framework if it is to contribute successfully to the Doha Development Agenda (DDA): (a) by ensuring that trade is effectively mainstreamed into the development plans and strategies for poverty reduction, so that trade works for the development of the LDCs and to help reduce poverty; and, (b) by building the human and institutional capacity to enable them to participate effectively in the multilateral trading system. This mainstreaming will be an essential priority of WTO-World Bank cooperation in the future, at least within the objective of completing the DDA by 1 January 2005.

2. Trade, monetary and financial policies

One of the main concerns of traders and trade officials has always been to depend on a stable international price mechanism for conducting cross-border transactions, for taking decisions on investment and production of tradable goods and services, and for setting price-based trade policies. In this regard, a key reference in the Marrakesh Ministerial Declaration on Coherence is the need for a high degree of exchange rate stability to reduce risk for investors and traders, and to give WTO Members confidence that they can live with a good degree of comfort within the rules-based trading system, without recourse to quantitative restrictions or excessive contingent protection. While the issue of exchange stability is at the heart

[40] Between 1990 and 1998, 68 per cent of World Bank adjustment programmes included support for reform of trade and exchange rate policies. World Bank lending for trade-related activities, broadly defined to include infrastructure, accounted for around 26 per cent of its total lending from 1994 to 1999 (about US$2 billion a year). World Bank staff are currently creating a detailed inventory of their trade-related lending activity.

[41] Speech by the Director-General of the WTO, 1 November 2002, Second Integrated Framework Mainstreaming Seminar.

[42] Speech by the Director-General of the WTO, 1 November 2002, id.

of the Coherence mandate, the IMF or the WTO can do little by themselves to correct major exchange rate disequilibria. However, the competent institutions can improve their complementarity by developing their respective roles as shock absorbers of economic crisis transmitted through large exchange rate fluctuations. Of course, as seen above, the system plays an important role in providing stability and economic security in periods of financial crisis, by making recourse to protectionism more difficult and by keeping markets open so as to ensure that crisis-hit economies are able to continue to count on exports. In addition, the dispute settlement system ensures that specific sectors, that are prone to large cyclical swings, do not contribute to deteriorate trade relations. The role of trade liberalization is also important in efficient resource allocation and in building the resilience of economies to external shocks. On its side, the IMF aims at strengthening the financial sector of emerging economies, which in turn limit rapid reversals in market sentiment. Early warning indicators of crises have been developed, and appropriate facilities have been developed for crisis-hit economies. All these initiatives aim at increasing the role of international financial institutions as "shock-absorbers" of financial crises and at avoiding the transmission of its effects to the "real economy".

One of the most promising avenues of work stemming from the identification of the link between trade, debt and finance, based on the work of the WTO Working Group on Trade, Debt and Finance, was the need to improve the stability and security of sources of trade-financing, especially to help deal with periods of financial crisis when access to traditional instruments, such as letters of credits, is denied by international banks. Concrete work undertaken by the WTO in this area is described in the following section.

3. Trade and debt policies

Trade enters the calculation of debt restructuring policies as a means of reducing the overall adjustment burden, since the long-term solution in all cases is for indebted or financially-stricken countries to increase their export earnings. International borrowing is equivalent to deferred trade, even when it is purely speculative. In the case of the Asian financial crisis, the crisis-hit countries shouldered most of the adjustment burden under IMF-World Bank supported-programmes, with consequences for their domestic economic activity. This general point about sharing the costs of adjustment is the same one that the Heads of the IMF, World Bank and WTO made in their tripartite Declaration, prior to the 3rd Ministerial Conference, when they pressed the WTO for new, preferential, market access opportunities to be created for HIPC countries to complement the debt relief programmes of the IMF and World Bank. In this area, it seems that the main contribution the WTO could make is to press ahead with increased market access in areas of interest to indebted countries. Overseas market-access restrictions are found to impede the ability of indebted countries to earn the foreign exchange they need to service their external debt and to avoid resort to further unsustainable borrowing. In addition, by any measure the gains that could be derived from eliminating barriers on these countries' exports would outweigh the annual flows received of official development assistance (ODA) and debt relief under the HIPC Initiative. Trade policies also have a role to play at the domestic level to improve the "supply capacity" of individual countries to meet export opportunities. Liberalizing imports in developing countries helps boost domestic growth, productivity and exports, although careful consideration should be given to the timing and sequencing of trade reform in this context, as well as to the costs of adjustment involved in such liberalization and the assistance needed to meet these costs. Well-run trade reforms contribute to reduce the anti-export bias in domestic policies and promotes an open business environment.

4. Adjusting to trade liberalization

The WTO, the IMF and the World Bank all play a significant role in the trade liberalization process, at the country or at the global level. While economists emphasize the long-run gains from trade liberalization, policy makers are concerned about the short-run costs. In a Special Study (2003), the WTO seeks to identify tools at the disposal of government to smooth adjustment and minimize an economy's adjustment costs. Some of the study's conclusions include the following: trade liberalization is an agent of economic change but evidence shows that it does not lead to drastic changes in production structures; adjustment costs are typically much smaller than the gains from trade; government can identify individuals and groups that may suffer from the adjustment process, and adopt policies to alleviate the burden of change as well as policies to sequence and reduce the size of adjustment costs; and the

implementation of trade reforms at a gradual pace may have a beneficial effect on adjustment costs.

While recognizing the beneficial effects of multilateral trade liberalization for all WTO Members, the IMF has recently introduced a new policy aimed at mitigating the concerns among some developing countries that their balance of payments position could suffer, albeit temporarily, if multilateral liberalization changed their competitive position in world markets. Chief among these concerns is that broad-based tariff liberalization might erode the value of their preferential access to important export markets; that the phasing-out of quotas in world textiles trade in 2005 would expose them to greater competition; or that the reduction in agricultural subsidies might result in adverse changes in their food terms of trade. Under its new Trade Integration Mechanism, the IMF would stand ready to discuss with qualifying countries facing such balance of payments shortfalls, the provision of increased resources under the countries' existing facilities to meet the increased and temporary needs.[43]

[43] IMF Press release No. 04/73 of April 13, 2004.

V. CONCLUSION

The work on trade finance, which provided a boost to the efforts of the various stakeholders to propose imaginative solutions, was the first among eight topics that the WTO Working Group on Trade, Debt and Finance selected in 2003 for further examination or action.[44] All areas do not necessarily involve action by the WTO, as the solution may not always belong to the WTO. For some issues, such as market-access-related areas, the analytical work done under the aegis of the group is within the remit of the WTO, although the real solutions lie in the effective participation of all Members in the world trading system. Remaining areas to be examined according to the following terms:

Themes to be addressed in particular to the WTO

- **Trade liberalization as a source of growth**. Trade liberalization is among several factors that can improve the allocation of resources at national and international levels, and hence improve the resilience to external shocks. As a factor in improving productivity and the allocation of resources, trade liberalization can impact favourably on the debt servicing capacity of economies, as it may result in increased sources of foreign exchanges such as net exports and foreign direct investment. Provided that trade liberalization and reforms are sequenced and timed properly, taking into account the special needs of developing countries, they could also reduce adjustment costs and enhance the ability of these developing countries to reap benefits from them.

- **WTO rules and financial stability.** The WTO system is playing an important role in providing economic stability and security, particularly in periods of economic or financial crisis. The "shock absorbing" nature of the system was tested during the emerging markets' financial crises in the late 1990s. The existence of a strong rules-based multilateral trading system renders recourse to protectionism more difficult and helps keep markets open, so as to ensure that crisis-hit economies are able to continue counting on exports as one source of foreign exchange and income growth. Some crisis-hit countries have noted that self-restraint from trading partners in the use of contingent protection was of great help in overcoming the crisis, and suggested that this be examined further in the appropriate fora of the WTO.

- **The importance of market access and the reduction of other trade barriers in the Doha Development Agenda's negotiations**. Non-discriminatory substantial reduction of trade barriers by WTO Members in the context of current WTO negotiations, under the Doha Development Agenda, especially in areas where Members' barriers affect products of export interest to developing countries, can be a valuable contribution that the WTO can make, within its remit, to improving their opportunities for growth, and to overcoming the problem of external indebtedness of developing countries by increasing their ability to earn the foreign exchange they need. Relevant studies suggest that the gains that can be derived from eliminating barriers on these countries' exports outweigh and complement the annual resource flows they receive of ODA and debt relief – flows that the Monterrey Consensus has pledged to increase.

Themes addressed in particular to the WTO and the IMF (with possible help from partners such as the World Bank and regional development banks)

- **Trade and financial markets**. In the 1990s, deep financial crises in part affected trade flows in a number of WTO Members. Following a first examination, and while recognizing current efforts to strengthen the financial architecture, Members wish to improve their understanding of the trade and trade policy implications of a perceived greater volatility of financial markets and exchange rates world-wide. Other issues involving financial services that have a bearing on on-going work of the WTO and other relevant international organizations, should remain

[44] WTO Document WT/WGTDF/2.

under review in the WTO. Interest was expressed by some Members that other forms of investment related to trade should also be kept under review.

- **Trade-financing**. Based mainly on experience gained in Asia and elsewhere, there is a need to improve the stability and security of sources of trade-financing, especially to help deal with periods of financial crisis. Further efforts are needed by countries, intergovernmental organizations and all interested partners in the private sector, to explore ways and means to secure appropriate and predictable sources of trade-finance, in particular in exceptional circumstances of financial crises.

Themes addressed to the WTO, the IMF and the World Bank

- **Better coherence in the design and implementation of trade-related reforms and monitoring.** As recognized by the Marrakesh Declaration on the Contribution of the World Trade Organization to Achieving Greater Coherence in Global Economic Policymaking, the inter linkages between the different aspects of economic policy require that the international institutions with responsibilities in trade-related areas follow consistent and mutually supportive policies. Therefore, a better scheduling and integration of the work of these international organizations in areas such as capacity-building and trade infrastructure, including fiscal and customs management**,** as well as policy advice and monitoring, could benefit Members.

- **The inter linkages between external liberalization and internal reforms**. The importance of the interface between external liberalization and internal policies has been acknowledged. To maximize the benefits of such liberalization and the integration of individual Members in world trade, Members' policies should also be geared to stimulating the supply-response to market opportunities, taking into account their individual capacities and needs. This could involve specific actions to raise domestic private savings and encourage foreign direct investment, in line with the Monterrey Consensus**,** and to remove obstacles that hinder the development of exports such as high transport and handling costs, and the poor state of trade infrastructures.

- **External financing, commodity markets and export diversification**. The difficulties of most developing countries to attract development finance, from private or public sources, are acknowledged. The lack of external financing is an important element in limiting their ability to diversify their exports. Interest was expressed in improving Member's understanding of factors that lead to high volatility in commodity markets and of factors hampering developing countries' efforts to move away from commodity exports, despite notable domestic reforms underway.

For some topics, more in-depth analysis, such as the links between external financing, commodity-dependence and export diversification, is needed to see to what extent the WTO can be involved in finding solutions. Likewise, the links between financial services liberalization, prudential supervision and capital account liberalization, although subject to a number of analyses by the IMF and the WTO in recent years, are not entirely clear, particularly in relation to the impact of GATS commitments on capital account liberalization, the issue of the use of balance of payments safeguards and other issues. With respect to "coherence"-related questions, there is at present considerable technical assistance devoted by the three international organizations to trade reform (tariff reform under the fiscal affairs department of the Fund, customs reforms operated by UNCTAD-the World Bank and the IMF, advice provided in the context of the Trade Policy Reviews and the integrated framework by the WTO). There is interest among the Membership of all international institutions in seeing a greater integration of international efforts in these area. By going deeper into the issue, economies of scale or scope for better sequencing may appear. As the architecture of the international trading system evolves, as the architecture of the international financial system strengthens and as trade is being increasingly mainstreamed in the national development strategies of Members, there might be a continued need in the WTO, under whatever form (including under the Coherence Mandate) to continue to examine "cross-border" issues, in particular those related to trade, finance and debt.

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