WORLD TRADE ORGANIZATION

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PREPARATIONS FOR THE FOURTH SESSION OF THE MINISTERIAL CONFERENCE

Proposal for the Establishment of a Working Group for the Study of the Inter-Relationship between Trade and Finance

Communication from Cuba, Dominican Republic, Honduras, India, Indonesia, Kenya, Malaysia, Pakistan, Sri Lanka, Tanzania, Uganda and Zimbabwe

The following communication, dated 31 July 2001, has been received from the Permanent Mission of Pakistan.

Rationale

1. It is well recognized that international trade and finance both play a central role in development. But due to the influence of the currently dominant neo-liberal economic thinking, the policy objectives seem to have been turned on their head. There have been strong pressures to adopt policies which focus on promoting international trade and finance for their own sake, without reference to their implications for development, rather than formulate international trade and finance policies which are designed to promote development. Viable mechanisms should be devised to ensure the promotion of development, taking into account the discussions on the link between trade and finance that have taken place so far. The current thinking presumes that liberalization of trade and market oriented finance policies provide development by themselves.

2. There are few who would deny that improved and diversified access to markets in the North for the products of developing countries, and remunerative and stable prices for their commodities, would generate more income and thus more financing for development in the South. Further, it is clear that less exchange rate volatility and speculation in the financial markets, and hence fewer or less serious financial crises, would assist trade and development. The creation of mechanisms for balance of payments support and for assistance to countries undergoing unexpected export shortfalls would also be helpful. FDI inflows into those sectors of the economy which produce for export and which contribute to domestic development would reduce the need for external financing, as would a reduction in the burden of external debt. There are many ways in which improved trade performance and opportunities would add to the resources available for development and there are many ways in which a more stable and development oriented financial system would enable developing countries to increase the benefits from international trade. Policy advances on both fronts would contribute to economic growth and development.

3. In sum, the issue is whether the international community can agree to reform the international trade and financial and monetary systems and provide the appropriate institutional framework such that there is a more consistent and mutually supportive policy framework in the two fields of trade and finance, with a view to providing developing countries with a more predictable environment for their development. The Bretton Woods Institutions started a reform process in 1994. An assessment of what has been “reformed: so far and with what results, particularly from the point of view of trade and

finance from a development perspective, needs consideration. The G24 (that represents developing countries at the IMF/World Bank) is monitoring this issue. The WTO Working Group on trade and finance should include the G24 inputs on the link between trade and finance.

4. A necessary element of a new more integrated framework in the fields of both trade and finance must be the acceptance of the need for different policies for countries at very different levels of development, in recognition of the differences between the economic structures of the developing and the advanced industrial countries and the persistent tendency towards external imbalances associated with the development process. Putting all countries on a "level playing field" by making no meaningful distinction in the way they are treated in policy terms has not proved conducive to development.

5. It is important to appreciate that the problems of financial volatility, speculative trading in foreign currencies, currency and stock market collapse and generalized economic crisis referred to in the background to the proposal are not only associated with "new external and financial and monetary disruptions" such as those resulting from the activities of dedicated "hedge funds and other highly leveraged institutions". The liberalization of financial systems in recent years in many developing countries has given rise to an increase in the inflow and outflow of various types of finance, all of which are subject to volatility. Volatile capital flows are nowadays also part and parcel of investment by TNCs. In addition to engaging in green-field investment and bringing in foreign direct investment (FDI) of the so-called bricks and mortar kind, TNCs also borrow local funds to secure finance that can be repatriated quickly and they engage in currency hedging operations to reduce their risks. Their investment and business activities thus embrace FDI, foreign portfolio investment (FPI) and other forms of investment, all of which are highly liquid and often volatile. (It should not be forgotten either that FDI often takes the form of mergers and acquisitions.)

6. The roots of most recent financial crises can be traced to surges in the inflow of capital (especially of FPI and short-term foreign currency denominated borrowing by domestic banks.) Avoiding a detrimental impact on the money supply and interest rates and preventing adverse pressures on the exchange rate pose a serious challenge for macro-economic management. The inflows may act in a pro-cyclical manner and overheat the economy or fuel an inflation of equity and property prices and thereby encourage unproductive investment, and/or a boom in consumption. When the dislocations are seen to be such as to make doubtful the continuation of the boom, short term investors seek to make a rapid exit in herd-like fashion, with a consequent run on reserves. Interest rates are increased to stem the capital outflows and protect the exchange rate, which in turn can have detrimental consequences for both investors and borrowers.

7. It is clear that the rapid growth and diversification of financial instruments, the liberalization and globalization of capital markets, and the frequency of crises with potentially severe implications for the global financial and monetary system pose continuing threats to international trade and the multilateral trading system.

8. More generally, in the absence of stable and rising export revenues, resort to other sources of external financing becomes necessary. What form this finance takes -- public or private -- is a key issue, and a number of the relevant issues will necessarily have to be addressed, regarding the relationship between the international financial and monetary system and international trade and the multilateral trading system.

9. It should be recalled that many WTO Members argue that the principal advantage of the GATT/WTO process and rules of the game are that they provide a degree of certainty and predictability. This, it is argued, provides the best possible guarantee against protectionism and large reversals in trade in adverse economic circumstances.

10. From a developing country's perspective, certainty and predictability in relation to continued expansion of trade are also intimately linked. This is because the GATT/WTO multilaterally agreed rules (the content of agreements) are an important factor determining the extent to which developing countries actually benefit from further liberalization efforts. Other major determinants are financial and monetary disruptions, which can have a detrimental impact on export earnings, due to exchange rate changes, and on the balance of payments.

11. When considering the issue of certainty and predictability in relation to a continued expansion of trade, it is obviously necessary to focus on the value and not just the volume of trade. In this context it needs to be appreciated that the often quite considerable changes in developed country exchange rates have a significant impact on developing country trade. The issue of the exchange rate regime is therefore an important one.

12. In addition to the above, an important issue to be studied is that concerning the measures required in order to provide a greater degree of certainty regarding commodity prices and earnings, while at the same time encouraging diversification, (whether through price stabilization, compensation, insurance or other schemes). Developing countries need strong and stable commodity prices if their development process is to proceed smoothly.

Reforms to ensure that Members benefit from further liberalization efforts:

13. In discussing reforms that may be necessary to ensure that Members genuinely benefit from further liberalization, developing countries will presumably wish to focus discussion on what can be done to ensure that future initiatives to liberalize trade in goods and services does in fact serve the interests of developing countries.

Proposals

14. On the trade front, and on the broad range of trade-related matters within the WTO ambit. There is a need to be focused on the following central issues in particular:

- The institutional measures that need to be taken to facilitate greater and more effective participation by developing countries in WTO proceedings;

- As mentioned earlier, new conceptual and substantive approaches to multilateral agreements involving developed and developing countries are needed to provide a different notion of "level playing fields", based on recognition of their different objective circumstances, which put them at a disadvantage compared with advanced economies;

- An important lesson of economic theory is that, in order for the full benefits to be derived from an open trading system, there must be full utilization of resources, notably full employment. It should be the task of the international financial and monetary system to ensure this by pursuing appropriate policies to this end. One essential element would be a coordinated effort by the developed countries to achieve a higher level of world demand;

- In order to ensure that developing country Members benefit from further trade liberalization, it is worth repeating that developing countries themselves must engage in "internal" reform, in the sense that greater and more structured efforts need to be made to develop a common platform on these matters so that they are better able to advance their individual and joint interests.

- There is a need to develop a new more coherent framework in the fields of both trade and finance with the recognition of diversity of appropriate polices based on diversity of levels of development and national situation.

- To ensure preservation of national policy autonomy.

- Consider mechanisms under the umbrella of coherence to alleviate the situation of countries damaged by financial instability particularly exchange rate instability.

- To develop a multilateral surveillance system both to coordinate macroeconomic policy and to ensure that these policies were compatible with the requirements of development policy.

- To examine the trade implications of exchange rate instability and impact on BOP on a country by country basis.

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