13

Trade, Debt and Finance: A Complex Agenda for the WTO

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1 Introduction

At the close of the last millennium, the international community succeeded in achieving two goals: firstly, in 1995, a long desired ambition of having a rules-based international trade body called the World Trade Organisation was set up; secondly, in 1996, a new debt relief initiative for the heavily-indebted poor countries (the HIPC Initiative) was launched by the International Monetary Fund and the World Bank. The progress on these two fronts is crucial in the fight against poverty.

Earlier, worldwide events in the 1970s and 1980s – particularly the oil price shocks, high interest rates and recessions in industrial countries, and then weak commodity prices – were major contributors to the debt build-up in the HIPC countries. After rising by 12 per cent per year from 1970 to 1980, commodity prices dropped sharply in the early 1980s. Countries partly compensated for declining terms of trade with increased foreign borrowing.

The external debt of all HIPCs combined was some $200 billion at the end of 1998. Although small in nominal amount compared with the more than $2 trillion owed by developing countries overall, the debt of the HIPC countries was, on average, more than four times their annual export earnings, and 120 per cent of GNP. Behind these figures is a deep human dimension that cannot be ignored. HIPCs are among the poorest countries on earth. Of the 600 million people in HIPC countries, more than one half live in absolute poverty, defined as living on less than one dollar per day (Chandrasekhar, 2000).

The launching of the Uruguay Round of trade negotiations in the mid-1980s and its culmination in the establishment of the WTO in 1995 resulted in opening up of domestic markets for trade by member nations. It has also led to an increased emphasis on international trade in the national economic policy of member nations.

The 1990s witnessed a boom in world trade, with an average annual increase of 6.3 per cent in the volume of global merchandise trade (1990–99) – outpacing global GDP growth by an average 4.2 per cent per year over the same period. Developing countries as a whole improved their penetration of world markets by increasing their share of global exports by 7 per cent, to about 25 per cent of world non-energy merchandise trade. But, the export share of the 49 least developed countries (the majority of which fall under HIPCs) shrank from 3 per cent in the 1950s to around 0.5 per cent in the early 1980s, and has hovered around this very low rate over the last two decades (UNCTAD, 2001).

The low level of trade integration of LDCs can be attributed to several factors. Apart from the high level of trade protection on agricultural products and labour-intensive manufactures, which together account for about 70 per cent of LDC exports, and some behind-the-border trade barriers, such as lack of social and economic infrastructure, the chronic and increasing levels of debt experienced by developing countries have also been identified as one of the major factors for LDCs marginalised status in the global trading landscape.

'Trade as an engine of growth' can work well when foreign exchange earned through exports is reinvested to build up domestic export capabilities. But high indebtedness results in an outflow of foreign exchange in terms of debt servicing. In other words, high levels of external debt have a negative impact on the ability of indebted countries to take advantage of the trading system. A significant reduction of the debt burden, by way of debt relief or cancellation, would free resources they need to increase public investment in export-capacity improvements and loosen the foreign exchange constraints that limit their options for implementing a well-sequenced trade policy at the service of national development goals.

The expansion of trade also depends on a reliable, adequate and efficient source of financing, both long term (for investment in tradeable goods and services) and short term (financial instruments that allow 'real' transactions to be protected from instability in asset prices and for trade-financing). An efficient domestic banking system plays a key role in providing financing, as well as financial services related to trade.

The establishment of the Working Group on Trade, Debt and Finance (WGTDF), pursuant to paragraph 36 of the Doha Ministerial Declaration, offers an opportunity to reform international economic policies on the basis of an integrated developmental approach to trade, debt and finance. Such a reform needs to be directed towards the goal that multilateral trade rules and financial and debt policies work together as a whole to support the equitable and sustainable development needs of developing countries.

The *demandeurs* for examining this relationship were developing countries seeking ways to reduce their public debt burden in the context of the multilateral trading system. However, many developed countries consider that the exercise is of little or no use due to the limitations of the trading system in addressing international debt and finance problems.

Given this background, Section 2 of this paper explains the linkages between trade and debt and trade and finance. Section 3 outlines Working Group mandate and its work programme. Section 4 focuses on the current state of play and analyses Members' submissions. Section 5 describes the progress made in the Working Group so far. Finally, Section 6 ends with conclusions and policy recommendations.

2 The Linkages

Trade and Debt

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 was recognised by G8 leaders in 2002, as well as by the Bretton Woods Institutions and the WTO, when emphasising the complementarity of initiatives to reduce indebtedness and to improve market access for poor countries.

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. 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:

- 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.
- At the world level, estimates of the gains from further liberalisation of merchandise trade range from US$250–550 billion, roughly one-third of which would accrue to developing countries. This is well in excess of the annual aid and debt relief flow.
- Liberalising trade restrictions can have a positive impact on external debt and debt servicing, as it tends to boost domestic growth, productivity and growth. It has been 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.
- 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. A recent paper by Pattillo, Poirson and Ricci (2002) tries to answer to the question of why large levels of accumulated debt lead to lower growth and under what conditions this occurs. They test the 'debt overhang' theory, which shows that if there is some likelihood, in the future, that debt will be larger than the country's ability to repay, 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.

Trade and Finance

As already mentioned, the expansion of trade depends on a reliable, adequate and efficient source of financing, both long term and short term. An efficient domestic banking system also plays a key role in providing financing, as well financial services related to trade.

The importance of a well-functioning international financial system has always been a matter of priority for international trade and the multilateral trading system. It figured in the drafting of the GATT, where attention was paid to ensuring complementarity between the multilateral trade rules and the financial policy disciplines of the IMF. It received attention in various GATT bodies, particularly in the late 1970s and early 1980s, by the (then) Contracting Parties, and it was elaborated upon in several areas of the Uruguay Round negotiations.

The result is that provisions that might be deemed relevant to the relationship between trade and finance can be found in many WTO Agreements and related ministerial declarations and decisions.

An important issue in this respect is balancing the advantages that can accrue from liberalising trade in financial services with the need to ensure that liberalisation is properly timed, sequenced and prudentially managed so that it does not become a source of financial instability in its own right. 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.

The expansion of trade also 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, and in normal circumstances this is the case. However, 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 a government may 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. To the extent that 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.

Therefore, two issues of particular concern have been the need for exchange rate stability to provide a predictable price mechanism for conducting international transactions, price-based trade policies and trade negotiations, and the need to ensure that the rules-based trading system is not frustrated by the undisciplined use of multiple exchange rate arrangements or exchange restrictions.

3 Working Group Mandate

In the preamble of the Doha Declaration, trade ministers recognised that the 'challenges Members face in a rapidly changing international environment cannot be addressed through measures taken in the trade field alone', and decided to 'continue work with the Bretton Woods institutions for greater coherence in global economic policy-making'. The Declaration introduces a binding mandate for Members to examine the relationship between trade, debt and finance in the WTO. To this end, ministers established a Working Group on Trade, Debt and Finance, open to all Members, to operate within the permanent structure of the WTO.

The agenda of the WGTDF consists of three core issues: the relationship between trade and finance; the relationship between trade and debt; and greater policy coherence between relevant institutions. At its meeting on 11–12 July, the Working Group adopted its Work Programme for 2002 contained in WT/WGTDF/W/1/Rev.1 (see Box1), and agreed that it would focus on the issue of 'the relationship between trade and finance' at its July meeting, 'the relationship between trade and debt' at its September meeting and 'towards greater coherence' at its December meeting. While Members have tabled few proposals, institutions such as the IMF, the World Bank, UNCTAD, the OECD, regional development banks and UN regional economic commissions have made many presentations to the working group.

4 The Current State of Play

As the *demandeurs* for the WTO involvement on debt and finance issues, several developing countries and groups have made submission before the WGTDF. Notable ones are African Group, the Economic Commission for Latin America and the Caribbean (ECLAC), the United Nations Economic Commission for Africa (UNECA),

Box 1. Working Group on Trade, Debt and Finance

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Revision 1

I. The Relationship Between Trade and Finance

- Financial Architecture and Trade
- Trade Policy and Financial Stability
- Any Relevant WTO Provisions
- Other Topics Raised by Members

II. The Relationship Between Trade and Debt

- External Debt and Trade
- Trade-Related Issues and Alleviation of the External Indebtedness of Developing and Least-Developed Countries
- Any Relevant WTO Provisions
- Other Topics Raised by Members

III. Towards Greater Coherence

- Assessment of Work in Progress
- Orientation of Future Work

Cuba, Indonesia and Argentina. The European Commission and major intergovernmental organisations such as OECD, UNCTAD, the World Bank, IMF and ADB have also contributed towards the discussion in the WGTDF through their detailed submissions. These international intergovernmental organisations have been granted observer status in the WGTDF.

Analysis of Developing Countries' Submissions

The African Group made one of the most useful submissions to the WGTDF (WT/WGTDF/W/16). Because of their high external indebtedness this issue is far more important to African countries than to any other country or region of the world.

The group in its submission argues that the poor trade performance of African countries can be directly linked to their unsustainable debt levels, as reduced export earnings from declining commodity prices hamper their ability to meet debt-servicing obligations. Conversely, ballooning debt service payments are a drain on the exchequer, which would have otherwise provided resources for enhancing trade capacity. The working group could, therefore, engage the Bretton Woods institutions with the aim of re-invigorating the debt reduction agenda by identifying the shortcomings of the previous initiatives. UNCTAD's contribution to this policy dialogue will be highly desirable.

The work envisaged for this working group, in essence, requires greater co-operation with the Bretton Woods institutions so as to contribute to achieving greater coherence in global economic policy-making in line with Article III.5 of the Marrakesh Agreement establishing the WTO. Further, Part IV of GATT 1994 on Trade and Development provides an explicit mandate for the WTO's role on development matters under the rubric of global economic governance.

The marginalisation of Africa in the multilateral trading system and in international capital markets is not an irreversible phenomenon. African governments have embarked on economic reform programmes at national and regional levels, whose overriding goals are poverty eradication through, *inter alia*, integration into the global economy on equitable terms. Such efforts require the complementary support of the international community. In this regard, the working group, as an appropriate forum for linking multilateral trade policy with other economic policy measures, can make a positive contribution to the crafting of development strategies.

The African Group submission made some specific recommendations to the fifth ministerial conference (see box 2). This includes a review of existing WTO Agreements with a view to addressing financial instability and external indebtedness, ways and means of diversifying African countries' exports and monitoring of the implementation of the 'Monterrey Consensus'. Here, particular mention has been made of UNCTAD communication (WT/WGTDF/W/5), which contends that the external account imbalances of African countries stem from debt and debt servicing payments and not trade deficits.

The United Nations Economic Commission for Africa (UNECA) has made its submission on a request by the Chairman of the WGTDF (WT/WGTDF/W/11). The UNECA in its submission highlighted how the economic and social impact of the debt service burdens on the economies of developing countries raises serious economic, social and even moral issues. In the African context, with most countries heavily dependent on exports of commodities for financing government expenditure, mounting external debts and debt servicing have siphoned off a significant proportion of export earnings, with critical adverse implications for poverty reduction and social programmes.

The paper emphasises that trade liberalisation on its own without a grasp of the underlying forces is likely to severely constrain the scope of trade leading to structural change in developing and African countries. This requires adopting an integrated approach encompassing the following aspects:

Box 2. African Group Recommendations to the Fifth Ministerial Conference

- Review of existing relevant WTO Agreements with a view to addressing financial instability and external indebtedness. Such a review should be oriented towards identifying the causes of the external account imbalances consistently experienced by African countries;
- Ways and means of contributing to the diversification efforts of African countries away from commodity dependence to value-added exports. The design and actualisation of an international commodity policy, in co-operation with other relevant organisations such as the Common Fund for Commodities, is a crucial element of the expected outcome of the work of this Working Group;
- The WGTDF could also serve as the WTO body tasked with the monitoring of the implementation of the outcome of the UN Conference on Financing for Development. The direct relationship between trade performance and financing requirements for addressing supply-side constraints provides the rationale for this undertaking;
- Exchange of experience among Members on the impact of capital account liberalisation on exchange rates and hence competitiveness. The IMF, Regional development banks and UNCTAD should be invited to contribute to this debate.

- *Market Access*: A broad-based approach to market access needs to be worked out encompassing not only removal of all barriers to trade in developed countries but also positive support to developing countries such as exemptions/food security guarantees and supply-increasing capacities;
- *Terms of Trade*: The falling terms of trade have deprived developing countries of capacities for restructuring their domestic economies. Hence, protection through tariffs is required to enable developing countries to develop their infant industries and then enter the global market. Accordingly, trade and industrial policies are directly linked. Under trade liberalisation all this has been brushed aside and it is essential that WTO post-Doha thinking should reassess these issues. This is especially important in the case of indebted African nations;
- *Trade Liberalisation and De-industrialisation of African Economies*: Only a few African countries have benefited from trade policy reforms , while others have seen de-industrialisation of their economies as local companies have had to compete with foreign forms for domestic markets. The most vivid example of this has been in the textile and clothing industry where second-hand clothing and cheap textiles imported from abroad have wiped out local industries. It is important, therefore, that the international community takes cognisance of the negative aspects of global-

isation and liberalisation on the economies of developing countries;

- ***Trade Policy, and the Fallacy of Composition and Debt:*** It is important to recognise that many African countries are given the same advice – to increase the exports of their commodities. This carries the risk of increasing supplies and depressing prices, with adverse implications for export income and hence capacity to contribute to debt reduction;

- ***The Link Between International Financial Instability and Trade:*** Financial policies should ensure that incapacity to repay debts and the 'debt burden', and the movement of speculative capital arising from financial liberalisation, do not work against trade policies. There is need to co-ordinate the role of trade institutions, such as the WTO supported by UNCTAD, and the Bretton Woods institutions in tackling financial concerns and the interrelationship between trade, finance and debt.

The discussions above have highlighted a number of important issues which will need to be addressed in the WTO Working Group on Trade, Debt and Finance if these discussions are to result in concrete proposals for effectively dealing with the interface between 'trade, debt and finance'. Based on the above points, the UNECA outlined a scope for a durable solution to the debt problem in the framework of the WTO Agreements (see Box 3).

The Executive Secretary of the UNECLAC, Jose Antonio Ocampo made a presentation before the Working Group on 'Mechanisms to Deal with Debt Overhang' (WT/WGTDF/W/10). He concluded by highlighting five issues for consideration by Members in the context of the Working Group:

(i) increased market access was crucial for countries affected by debt overhang;

(ii) flexibility in the use of balance-of-payments restrictions should be allowed for highly indebted countries;

(iii) there was a clear link between trade and financing during debt crisis, which should involve co-operation between the WTO and International Financial Institutions in terms of greater availability of trade financing and compensatory financing;

(iv) while special and differential treatment in favour of highly indebted developing countries was not justified in the light of distortions this might create against developing countries not affected by debt, the question arose as to whether there would be scope, within the WTO framework, for mechanisms that would limit the use of contingency measures by third countries against the exports of countries experiencing debt overhangs;

(v) indebted countries should be allowed to use capital account restrictions.

Box 3. UNECA's Proposal on the Debt Problem in the WTO Framework

- Need to take a holistic approach which encompasses trade policy issues (such as market access, declining commodity prices, supply constraints of developing countries and imbalances in the multilateral trading system), on one hand, with issues of 'development finance' (such as ODA, debt relief, and FDI), on the other;
- Current debt rescheduling and re-negotiation arrangements leave much to be desired and provide creditors with greater leverage than debtors. Accordingly, there is need to look for alternative arrangements which will ensure 'neutrality' in the institutions adjudicating on such disputes.
- Trade policies in both developing and developed countries impinge significantly on the capacity of developing countries to mobilise development finance. Accordingly, resolving the issues of the interface between 'trade and debt' on one hand and 'trade, debt and finance' on the other will require ingenious thinking by all those involved.
- Enhancing the relationship of the GATT/WTO with the relevant international organisations and taking account of the importance of an improved trading environment providing, *inter alia*, for the ability of indebted countries to meet their financial obligations.
- Strengthening the inter-relationship between trade policies and other economic policies affecting growth and development, and to contribute towards continuing, effective and determined efforts to improve the functioning of the international monetary system and the flow of financial and real investment resources to developing countries.
- Provisions in the WTO Agreements, which could be examined to determine whether they provide scope for dealing with the interrelationship between 'trade and debt'. These include the GATS Annex On 'Financial Services' which could be examined further in the context of the debt/finance interface; GATT 1994 Article XVIII: B on Balance of Payments Provisions which acknowledges balance of payments difficulties for developing countries that could arise as a result of instability of their terms of trade; and the Agreement on Agriculture, in which a link is made between falling commodity prices and 'unsustainable debt stocks'.

Cuba in its submission listed several issues, which it is essential to consider in the 2003 agenda of the WGTDF. It endorsed some of the recommendations made earlier in UNECA's submission, such as adopting a comprehensive approach that embraces trade-policy issues, on the one hand, and development finance issues, on the other, addressing the problems of commodity trade and supporting efforts to diversify developing countries' exports. Some of the key recommendations made by Cuba are as follows:

- The work programme should address the linkages between trade, external debt and finance from a global and multidimensional perspective, focusing on systemic problems;
- The imbalances caused by the multilateral trading system's promotion of all-out trade liberalisation need to be identified, since they are resulting in the de-industrialisation of domestic economies;
- The WGTDF should consider measures that ensure the gradualness, coherence and correct sequencing of the liberalisation process, to enable less developed countries to integrate into the world economy on a sustained basis;
- Trade policies need to be accompanied and reinforced by a broad reform agenda covering regulatory issues, institutional dispute-settlement mechanisms, sound macroeconomic management and greater labour-market flexibility;
- The WGTDF's agenda should include activities to identify technical assistance modalities, together with capacity-building to create the infrastructure and technical capabilities needed to exploit the opportunities provided by trade liberalisation, and to attract export-oriented productive investment;
- As long as less-developed countries continue to face major access barriers to rich country markets, the working group should focus on consolidating the principle of Special and Differential Treatment, and on strengthening and broadening its modes of application;
- The WGTDF should evaluate the underlying coherence of policies emanating from the co-operation agreements between the WTO and the Bretton Woods institutions. It should not only monitor their mutual coherence, but also ensure they are compatible with development of the poorest trading partners;
- The WGTDF could act as a mechanism for monitoring compliance with international commitments on development financing, particularly those arising from the Monterrey Summit;
- The WGTDF should continue to scrutinise WTO Agreements and provisions wherever links can be established between trade, debt and finance issues. It should propose specific additions or corrections and evaluate how best to link the corresponding WTO rules and the policies promoted by IMF and the World Bank, seeking to reform these institutions internally.

The most recent submission (WT/WGTDF/W/20) on trade, debt and finance has been made by Argentina on 28 March 2003. Its submission is mainly focused on market access issue for poor countries. It has been pointed out that the multilateral trading system currently lacks an appropriate mechanism for expanding market access for the highly indebted developing and least-developed countries. The WGTDF could, therefore, make a significant contribution towards solving these problems by conducting a more thorough analysis of the means or instruments that the multilateral trading system would require to enable the highly indebted developing countries to increase their exports in proportion to their level of indebtedness.

In short, Argentina considers that the examination of how the multilateral trading system could contribute to a lasting solution to the problem of the high level of external indebtedness of the developing and least-developed countries constitutes a key element of the mandate provided by the Ministers in Doha. Accordingly, Argentina proposes that the working group recommend to the fifth ministerial conference possible actions and measures relating to market access that could be adopted in the framework of the WTO in order to enable the highly indebted developing and least-developed countries to overcome this critical situation.

Analysis of Developed Countries' Submissions

Among the developed countries, the European Commission's submission (WT/WGTDF/W/8) is most comprehensive. The EC sees this process initially as one of information exchange and improving understanding of the problems and opportunities. This pertains to the underlying mechanisms and issues relevant to possible recommendations on the contribution of the multilateral trading system to tackling external indebtedness, and to the coherence of trade and financial policies.

The EC feels that issues related to trade, debt and finance cover several policy areas and fall under the mandate of different institutions. The process of information exchange and examination of the issues should therefore invite contributions from the relevant international organisations, such as the World Bank, IMF, UNCTAD and the regional development banks.

An important part of the work of the working group will be to look at ways to strengthen the coherence of policies of the different organisations, whose mandate relates to the trade-debt-finance nexus. In this context, the EC wishes to recall that in the Uruguay Round Declaration on the 'Contribution of the WTO to Achieving Greater Coherence in Global Economic Policymaking', ministers recognised that coherence between the structural, macroeconomic, trade, financial and development aspects of economic policy-making increases the effectiveness of these policies.

One important means to improve coherence will be to ensure better synergy between different policy areas through transparency and strengthened co-operation between relevant organisations. This, however, must not blur the distinct responsibilities of these organisations, each of which must continue to act within its own mandate and competence. In this context, the EC considers that the process of examining the interrelations and of considering possible recommendations for actions for the

Box 4. Issues for Consideration by the Working Group: An EC View

The EC wishes to underline a few issues that it considers of particular relevance for the work of the Working Group.

- **Trade liberalisation and indebtedness:** Trade liberalisation tends to decrease indebtedness by encouraging growth. However, because tariff cuts can cause a decline in fiscal revenue, attention should be given to possible complementary measures such as identifying alternative sources of fiscal revenue. Building administrative capacity is, of course, a highly relevant issue in this context. The working group could usefully address this issue and request relevant organisations (in particular, the IMF, but also WCO for customs simplification measures) to provide advice on reform measures, their sequencing and application.
- **Integrating trade in economic reform:** The working group could consider, together with relevant organisations such as the IMF, the World Bank and UNCTAD, as well as bilateral development partners, how best to integrate trade into economic reform programmes and ensure WTO conformity for sustainable reform. The Integrated Framework for Trade-related Technical Assistance to the Least Developed Countries is a useful example of a mechanism that integrates trade in the domestic economic and development policies.
- **Addressing supply-side constraints:** Many developing countries lack sufficient infrastructure and capacity to make use of the opportunities offered by trade liberalisation or to be able to attract productive and export-oriented investment. Measures to address supply-side constraints should therefore form part of economic reform programmes. The working group could usefully consider supply-side capacity-building in relation to economic reform programmes, and relevant organisations, such as UNCTAD and the World Bank, could be invited to present their activities in these areas.
- **Investment and indebtedness:** Foreign Direct Investment is an increasingly important source of foreign capital inflows for many developing countries. However, heavily indebted developing countries frequently suffer from economic instability and uncertainty, which makes it more difficult for these countries to attract foreign investment. The Working Group could, in co-ordination with the Working Group on Trade and investment, look at factors that help to attract FDI and consider recommendations that will support increased FDI flows to highly indebted developing countries.

WTO could possibly bring to light the need for complementary actions and measures that fall outside the mandate and competence of the WTO.

The WGTDF should also build on progress made in other fora, such as the Monterrey International Conference on Financing for Development. The EC welcomes the consensus reached at the Monterrey conference in favour of increasing the coherence and consistency of the international monetary, financial, and trading systems in support of development. In particular, the EC agrees on the need to improve the relationship between the UN and the WTO on development issues, and to strengthen their capacity to provide technical assistance to all countries in need of such assistance, with a view to increasing the global economic system's support for development.

The OECD's submission (WT/WGTDF/W/20) focuses on the role of trade policy in responding to financial crisis. First, it is critically important to resist protectionist pressures and to keep markets open, and for these efforts to be backed by a continued flow of trade finance; second, it is necessary to encourage regulatory reform and liberalisation of financial services; and third, it is necessary that sound trade policy be accompanied, and bolstered, by a broad reform agenda.

5 Discussions in the Working Group

The Working Group has held four meetings: on 15 April (Wt/WGTDF/M/1); 11–12 July (WT/WGTDF/M/2); 30 September (WT/WGTDF/M/3); and 17 December 2002 (WT/WGTDF/M/4) under the Chairmanship of Ambassador Hernando José Gómez of Colombia.

The Relationship between Trade and Finance

At the group's first meeting, in April, a representative of the IMF presented an overview of the IMF's work on the reform of the financial architecture. He noted that the major building blocks of its work encompassed transparency and accountability, the strengthening of financial systems, strengthened external vulnerability analysis, and standards and codes.

The chairman noted the IMF's view that participation in its financial sector assessment programme, together with the design and implementation of prudential standards, could help WTO Members assess their readiness to benefit from opening their financial services sectors. The standards initiative, pursued by the IMF and the World Bank, focused on the development of internationally-agreed standards and codes to promote strong institutional underpinnings for a stable international financial system. The IMF had also stated that the adoption of standards and codes of good practice contributed to the effective functioning of markets and created an enabling environment conducive to investment and trade. Furthermore, Members had suggested that the working group should examine a number of issues: exchange rates and their effect on competitiveness; how the present financial architecture responded to the financial needs of developing countries; and how trade-financing facilities could be strengthened and made more secure.

At the second meeting, in July, representatives of UNCTAD, the Asian Development Bank and the OECD made presentations based on their written submissions. In the ensuing discussion, a variety of issues was raised, *inter alia* exchange rate volatility and trade, the role of trade and trade liberalisation in periods of financial crisis, the sequencing of trade and financial policy reform, difficulties in securing trade-financing, fiscal reform and tariff liberalisation, and the use of trade restrictions for balance-of-payments purposes.

In summing up the discussions on the relationship between trade and finance on his own responsibility, the Chairman drew attention to the following themes:

- The value of the WTO system in providing stability and economic security in periods of financial crisis;
- The value of keeping markets open worldwide in periods of financial crisis, so as to ensure that crisis-hit economies are able to continue to count on exports for foreign exchange earnings and a source of income growth;
- The role of trade liberalisation in resource allocation and the resilience of economies to external shocks;
- The relationship between the exercise being carried out by the IMF and World Bank to strengthen financial systems and the negotiations being carried out by the WTO on financial services;
- Based on experience gained in Asia, the need to improve the stability and security of sources of trade-financing, especially to help deal with periods of financial crisis.

The Relationship Between Trade and Debt

At the third meeting, in September, presentations were made by representatives of the United Nations Economic Commission for Latin America and the Caribbean, the United Nations Economic Commission for Africa and the World Bank on the basis of their written submissions. In the ensuing discussion, a variety of issues was raised, *inter alia* the importance of export market access for indebted developing countries, problems linked to deterioration in the terms of trade, and the importance of alternative sources of foreign finance for developing countries (such as FDI).

In summing up the discussions on the relationship between trade and debt on his own responsibility, the Chairman drew attention to the following themes:

- Overseas market-access restrictions impeded the ability of indebted countries to earn the foreign exchange that they need to service their external debt and avoid resort to further unsustainable borrowing. Relevant studies suggested that the gains that could be derived from eliminating barriers on these countries' exports far outweighed the annual flows they received of ODA and debt relief – flows that the UN Conference on Financing for Development in Monterrey had pledged to increase;

- A global, non-discriminatory reduction of trade barriers in the context of the current WTO negotiations, especially in areas where distortions affect developing countries' exports, could make a significant contribution to a durable solution to the problem of external indebtedness of developing and least developed countries;
- At the same time, indebted countries could improve the debt-servicing capacity of their economies by properly liberalising their own trade regimes. This could help boost their domestic growth, productivity and exports. Careful consideration needed to be given to the timing and sequencing of trade reform in this context, as well as to the cost of adjustment involved in such liberalisation and the assistance needed to meet these costs;
- Trade policy reform in indebted countries needed to be supported by pro-growth policies that would involve, *inter alia*, raising domestic private savings and encouraging foreign direct investment;
- Further examination of the issue of the deterioration of the terms of trade was needed, as it affected the capacity of countries, despite notable domestic reforms underway, to service their debt and move away from commodity exports.

Also at this meeting, the group discussed a written submission from the European Community (WT/WGTDF/W/8), containing a number of ideas on the process of the working group, proposals on how to move to a more substantive phase of its work, and suggestions of concrete areas for improved Coherence between the WTO and other international fora.

Towards Greater Coherence

The WGTDF held its fourth meeting on 17 December 2002. The group focused its discussion on Item III of the group's 2002 Working Programme, 'Towards Greater Coherence', thereby continuing its educational process along the lines begun at previous meetings on the relationship between trade and finance, and trade and debt.

The Secretariat introduced its Note 'Towards Greater Coherence' (WT/WGTDF/W/17), which addressed the two sub-items of Item III of the 2002 Work Programme, namely the assessment of work in progress in the area of coherence, and orientations for future work. Section II of the Note described the Marrakesh Coherence Mandate and regular activities that were being undertaken under this mandate. It highlighted the fact that under Article III.5 of the WTO Agreement, achieving greater coherence in global policy-making through co-operation with the IMF and the World Bank was one of the five core functions of the WTO.

The Chairman then summarised the themes and potential areas of interest that had been raised by Members during the course of the discussion on this agenda item, and noted that Members had focused on:

- The effects of financial and exchange rate instability on trade, drawing on lessons to be learned from the financial crises experienced by emerging economies in the 1990s;
- The examination and possible establishment of mechanisms and facilities to keep trade finance alive in periods of financial instability;
- The need for better integrating the work of international organisations in the areas of capacity-building and trade infrastructure;
- The issues of the liberalisation of financial services, on the one hand, and the efforts underway in the international financial architecture, on the other, which had been raised several times, as well as the links between WTO and other institutions on long-term, cross-border investments, and capital account liberalisation. Although these two topics were being debated in other fora, they nevertheless had been part of the discussion of the Working Group on Trade, Debt and Finance, which encompassed systemic issues of this kind.

6 Conclusions and Policy Recommendations

After analysing various submissions on trade, debt and finance, it is clear that this issue covers a vast area. It has also been realised that neither trade nor trade measures alone can solve a country's debt problems, but some felt that trade needed nonetheless to be seen as part of the solution. However, the problem of indebtedness in the developing and least developed countries significantly impairs their capacity to share in the benefits of the multilateral trading system. The capacity of a country to service its external debt clearly depends on its trade balance.

The above analysis makes clear that the chronic and increasing levels of debt experienced by developing countries are perpetuated and exacerbated by structural imbalances of the trading system which include:

- A deterioration in the terms of trade;
- Lack of capacity and enabling conditions to diversify and upgrade exports;
- Serious trade distortions caused by developed countries' policies;
- The stagnation of export markets.

All these combined together make it difficult for a country to honour its external debt commitments, causing financial instability and monetary disruptions which, in their turn, have a negative impact on growth and economic development.

Therefore, finding a durable solution to the problem external indebtedness being faced by developing countries, as expressed in the mandate of the Working Group on Trade, Debt and Finance requires an integrated approach that should address the following issues:

- The need to significantly improve the price stability of commodities of export interest to developing countries as the correlation between primary commodity dependence and debt is shown by the fact that 85 per cent of LDCs dependent on non-oil primary commodities have an unsustainable external debt.
- The need to create an enabling environment for developing countries to diversify and upgrade their export productive capacity. In order to achieve this, the WGTDF should devise ways to resolve adverse terms of trade problems arising from the way in which industrial countries market access commitments and trade practices hinder the ability of developing countries to upgrade and diversify their economies into skill and technology-intensive and higher value-added production.
- The multilateral trading system currently lacks an appropriate mechanism for expanding market access for highly-indebted developing and least developed countries. The working group should make a significant contribution towards solving these problems by conducting a more thorough analysis of the means or instruments that the multilateral trading system would require to enable the highly-indebted developing countries to increase their exports in proportion to their level of indebtedness.
- Consider the possible establishment of a debt relief mechanism through which debt reduction initiatives can help developing countries strengthen supply-side capacity for export upgrading and diversification and open more options for trade policy design. Such debt relief or cancellation should not be at the expense of official development assistance or already committed debt relief such as the HIPC initiative of the World Bank.

On the issue of trade and finance, from the various submissions, both from members and observers, such the IMF and World Bank, it has been realised that for most developing countries, the present international trade and finance systems do not provide sufficient long-term financial resources to enable them to achieve rapid and sustained economic growth through expansion of trade. Full implementation of commitments by most developing countries undertaken during the Uruguay Round, together with continued restrictions in market access in some major industrial countries, are generating payments imbalances that cannot be financed on a sustained and reliable basis by private international capital flows.

Moreover, despite sustained international pressure, official financial flows continue to decline. The outcome of the Monterrey Financing for Development conference highlights this inconsistency; the additional pledges made in the context of this conference fall far short of the amounts needed to close the resource gap which, according to estimates made by the Zedillo Panel, as well as the World Bank, would require a doubling of official aid flows. In the absence of an increase in flows on this scale, many developing countries may have not only to curtail development plans but also to restrict their participation in the international trading system.

Given the decline in official development assistance, the provision of long-term financing for developing countries has been left to private capital flows. In direct contrast to those arrangements originally thought to be necessary to support the international trading system, current arrangements favour private capital flows over official flows, exchange rate flexibility over stability, austerity over expansion, adjustment over financing and the interests of creditors over debtors. They have moved international trade towards a single-tier system of rights and obligations in which developing countries have generally the same level of obligations as the developed countries.

Given this situation, it is much more important to find a durable solution to the deteriorating developmental finance, international financial instability and increasing exchange rate fluctuations that have adversely impacted on the ability of developing countries to reap the benefits of the multilateral trading system. Global financial stability is an indispensable element for the increased employment and outputs that would characterise a successful trading system. The recent and repeated financial crises in developing countries and the increased financial burden on developing countries resulting from the Uruguay Round commitments calls into question the effectiveness of current global arrangements to achieve global financial stability and provide developing countries with access to trade-financing capital. Therefore, the WGTDF should:

- Redesign the architecture of the international financial system with the basic objective of easing the integration of developing countries into the international trading system.

- Be entrusted with the task of monitoring of the implementation of the 'Monterrey Consensus'. The direct relationship between trade performance and financing requirements for addressing supply-side constraints provides the rationale for this undertaking.

- Strengthen the inter-relationship between trade policies and other economic policies affecting growth and development, and to contribute towards continuing, effective and determined efforts to improve the functioning of the international monetary system and the flow of financial and real investment resources to developing countries.

- Propose a redefinition of several provisions of the GATT 1994 and GATS. The balance-of-payments provisions of the GATT provide an alternative mechanism for the reduction in imports through temporary suspension of commitments. However, recourse is only made to these provisions infrequently because they were not designed to deal with problems endemic in the current international system and because of the difficulties in the procedures involved. This should lead to greater flexibility for developing countries facing balance of payments problems.

- Address the need to rethink the role of the IMF, especially with respect to Article XV:2 of GATT 1994 and Article XII:5(e) of GATS, in judging the adequacy of country reserves and other prerequisites that countries need to fulfil in order to implement current and capital account controls. As long as industrial countries that have conflicting trade interests with the country seeking to implement the restrictions continue to play a decisive role in the governance of the IMF, critical questions of conflict of interest will remain. Until those questions have been addressed, the IMF's judgement on such matters should be given only non-binding and recommendatory, rather than mandatory and conclusive, weight.
- Adequately address the systemic problems associated with insufficient development finance or secular declines in commodity prices and the export earnings of developing countries. While Article XVIII:A allows measures to promote 'a particular industry with a view to raising the general standard of living of its people', it is not clear how far this article can be applied more generally to a country that seeks to reduce its dependence on primary export earnings by promoting structural change, upgrading and diversification, processes which typically involve more than one sector or industry.
- Recommend, in line with the mandate of the UN Financing for Development Conference, the creation of a mechanism for ensuring the co-ordination of macroeconomic and exchange rate policies among currency reserve countries. This mechanism should take into account the impact of dramatic exchange rate fluctuations and misalignments on the trade performance and debt-service obligations of developing country economies.
- Call for the creation of a regular and predictable mechanism to ensure that developing countries can opt out of their trade obligations to the extent required to compensate for the impact of the exchange rate misalignments of their economies.
- Propose reforms for development aid policies and practices regarding the appropriateness of the institutional vehicles used to provide it and the conditions attached to it.