

PREPARATIONS FOR THE 1999 MINISTERIAL CONFERENCE

Interrelationship Between Trade and Debt

Communication from Ecuador

Addendum

Note on Trade, WTO and External Debt

The following communication, dated 18 October 1999, has been received from the Permanent Mission of Ecuador.

1. It is widely accepted that the integration of developing countries into the world trading system and thus their position in the GATT/WTO pose special problems. Although some of these problems have been recognized and partially addressed within the WTO/GATT framework (through Article XVIII of the GATT, the 1979 Decision on differential and more favorable treatment, etc.), others have yet to be the subject of systematic analysis or negotiation, and these include relations between trade, GATT/WTO, and external debt.¹

2. Misalignments of exchange rates and trade imbalances are generally acknowledged to be a major source of protectionist pressures which manifest themselves both in unilateral measures and in tensions threatening the rules of the multilateral trading regime. Similarly, it is generally agreed that financial crises and exchange-rate instability are a major threat to the trading system. These were clearly recognized by the architects of Bretton Woods who designed a system of relatively stable exchange rates, capital controls and provision of international liquidity to finance external imbalances in order to avoid deflationary adjustments. With the breakdown of the Bretton Woods arrangements, the increasingly frequent and virulent systemic breakdowns in the operation of international financial markets and the associated external debt-servicing difficulties have been generating frictions in the international trading system, not only by producing instability of exchange rates and frequently drastic shifts in international competitiveness, but also by generating deflationary forces whereby adjustments to crises take the form of economic contraction and import cuts rather than of export expansion.

3. It is equally true that imbalances in the trading system are a major cause of financial crises, currency turmoil and external debt servicing difficulties. Some of these linkages are self-evident :

¹ As a distinguished scholar of the GATT/WTO has put it in this context, "...the whole question of debt must be noticed. Developing-country debt is an obvious and extraordinarily difficult problem, and of course it relates to trade and the trade rules" (J.H. Jackson, *The World Trading System: Law and Policy of International Economic Relations*, 2nd edition (Cambridge, Mass. and London : The MIT Press, 1997), p.322).

- A country's ability to service its debt clearly depends on its trade balance. A worsened trade balance as a result of terms-of-trade deterioration, stagnant export markets or restrictions on market access can cause difficulties in servicing external debt, thereby leading to financial instability and currency turmoil, with attendant consequences for growth and development. It is, for instance, generally agreed that terms-of-trade deterioration and increased trade deficits played an important role in the outbreak of the East Asian crisis.²
- Through its influence on the balance-of-payments, the trade balance will also be a major determinant of the rate at which a country accumulates external debt. It has, for instance, been shown that in developing countries trade deficits now tend to rise much faster than incomes, resulting in increased dependence of economic growth on capital inflows, whose consequences include accumulation of external debt. Rapid trade liberalization in developing countries together with continued protectionism in industrial countries in areas of export interest to developing countries appear to have played an important role.³
- A country's trade balance and influences on it such as relevant economic policies and prospects for, and conditions in, its major export markets (via effects on its creditworthiness) will affect the types and terms of external borrowing to which it has access, and thus the structure, maturity and servicing costs of its external debt. A country suffering from declines in its export prices or restrictions on market access will experience considerable difficulties in access to international financial markets.

4. The growing integration of developing countries into international financial markets and their consequent vulnerability to swings in capital flows have implications for the relation of external debt to trade under all of the above headings. But there are also other subjects less frequently raised here but still deserving consideration in the context of rules and procedures likely to lead to more equitable participation of developing countries in the WTO. Amongst these is the question of the adequacy of foreign exchange reserves. The importance of this subject has been widely recognized in recent discussion of ways to prevent and manage financial crises⁴, but it also has implications for the justification of the imposition or maintenance of import restrictions under GATT and GATS.

5. In considering the justification of the imposition, maintenance or intensification by a country of exchange restrictions to safeguard its balance of payments, WTO Members are required – under Article XV of GATT and Article XII of GATS – to take as a basis the assessment by IMF of the country's balance-of-payments and other aspects of its external financial situation, such as the adequacy of its foreign currency reserves. Much of the case history of the application of GATT Article XV in this context relates to an earlier period, before the existence of the large international capital flows which have accompanied growing global financial integration. However, as implied by remarks above, in recent years payments pressures on a country can now be much greater as a result of increased international financial integration and have a different character. An approach to assessing the adequacy of a country's foreign exchange reserves should consequently make allowance for these new circumstances.

² See UNCTAD, Trade and Development Report 1998, Part One, Chapter III.

³ See UNCTAD Trade and Development Report, 1999, Part Two.

⁴ See, for example, the new guidelines proposed for policy in this area by Pablo Guidotti, Deputy Finance Minister of Argentina, and by Alan Greenspan, Chairman of the Board of Governors of the United States Federal Reserve System, to which attention is drawn in the context of crisis prevention in IMF, Statement and Report of the Managing Director of to the Interim Committee on Progress in Strengthening the Architecture of the International Financial System (Washington, D.C. : IMF, September 1999), p.7, and which are also discussed at greater length in UNCTAD, Trade and Development Report, 1999, pp. 110-111.

6. One approach proposed by UNCTAD would be to require the IMF for this purpose to take account of the many different elements of external sector statistics specified in its own Special Data Dissemination Standard (SDDS) for economic and financial data and of the volatility of several of the categories of external obligations included in the SDDS.⁵ Under the heading of balance-of-payments statistics, for example, the SDDS recommends a breakdown of relevant financial transactions between direct and portfolio investment, presumably because of the difference in volatility between the two. As regards the international investment position, it calls for a classification of external assets under the headings of direct investment, portfolio investment (with a breakdown between equity and debt), other investment, and reserves; and in respect of external liabilities it distinguishes (within portfolio investment) securities and loans according to the currency of issue and (for debt instruments) original maturity.⁶ This classification is clearly intended to comprise categories relevant to the evaluation of countries' external payments and international investment positions in a global economy characterized by large international capital movements. As such it could also serve as a starting-point for evaluation of reserve adequacy in the WTO.

⁵ *Ibid.*

⁶ Clearly, with regard to loans of a medium- or long-term original maturity it would be preferable to distinguish according to the residual maturity, which is a more important feature of the external payments and the international investment position of a country threatened by, or experiencing, a financial crisis to difficulties of obtaining refinancing, which can involve refinancing of medium- and long-term debt as well as rolling over short-term debt.