

International and Regional Trade Law: The Law of the World Trade Organization



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Unit XVI: Trade and Finance

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GUIDING QUESTIONS

- 1. Domestic financial restrictions, including those related to cross-border payments and exchange rates, may impede and hinder international trade flow. Note that these financial restrictions have recently begun to decrease. But why and to what extent?*
- 2. Exchange rate fluctuations and policies can still have a great impact to the actual volume of imports and exports. Would a devaluation of exporting countries' currencies result in dumping in importing countries?*
- 3. Would the India – QR (1999) case law change the traditional relationship between the GATT/WTO and the IMF?*
- 4. Which should come first? Trade Liberalization or Financial Liberalization? Should such sequence be different in developing countries vis-à-vis developed countries?*

I. LINKAGE BETWEEN TRADE AND FINANCE

1-1. Financial Restrictions as Trade Restrictions

1-1-1. Exchange Rate Restrictions

Excerpts From WTO Provisions Relevant to the Relationship between Trade and Finance and Trade and Debt (by WTO Secretariat), WT/WGTDF/W/3, 21 June 2002

(...)

III. Provisions related to Exchange Restrictions

A. General Agreement on Tariffs and Trade

Article XV

XV:1: "The CONTRACTING PARTIES shall seek co-operation with the International Monetary Fund to the end that the CONTRACTING PARTIES and the Fund may pursue a co-ordinated policy with regard to **exchange questions** within the jurisdiction of the Fund and questions of quantitative restrictions, and other trade measures within the jurisdiction of the CONTRACTING PARTIES".

Analytical Index: Article XV, para. 1

Relationship between trade measures and financial system

The Tokyo Declaration of 1973 which launched the Tokyo Round of multilateral trade negotiations noted that:

"The policy of liberalizing world trade cannot be carried out successfully in the absence of parallel efforts to set up a monetary system which shields the world economy from the shocks and imbalances which have previously occurred. The Ministers will not lose sight of the fact that the efforts which are to be made in the trade field imply continuing efforts to maintain orderly conditions and to establish a durable and equitable monetary system.

"The Ministers recognize equally that the new phase in the liberalization of trade which it is their intention to undertake should facilitate the orderly functioning of the monetary system".¹

At their Fortieth Session in 1984, the CONTRACTING PARTIES adopted a Decision on "Exchange Rate Fluctuations and their Effect on Trade" in which they "urge that their concern regarding the relationship between exchange market instability and international trade be taken into account in ongoing efforts within the International Monetary Fund to review the operation of the

¹ MIN(73)1, Declaration of Ministers approved at Tokyo on 14 September 1973, 20S/19, 22, para. 7.

international monetary system with a view to possible improvements” and “agree that they will keep under consideration through further exchanges of views the relationship between exchange market instability and trade”.²

(...)

Application of Paragraph 2: role of International Monetary Fund

In 1982-83 discussions took place concerning the treatment of balance-of-payments problems confronting heavily-indebted developing countries. A 1984 Statement by the Chairman of the Committee on Balance-of-Payments Restrictions to the Council, which summarized the result of these discussions, stated, *inter alia*, that:

“The suggestion, that measures relating to trade policy agreed upon under standby or extended facility arrangements with the IMF could be notified to the GATT, had already been strongly questioned during the discussions in the Consultative Group of 18. (...) Against this background, there was no evidence of support for the suggestion that there should be greater synchronization between consultations in the Committee and the consultations undertaken by the IMF”.³

XV:3: "The CONTRACTING PARTIES shall seek agreement with the Fund regarding procedures for consultation under paragraph 2 of this Article".

XV:4: "Contracting parties shall not, by exchange action, frustrate the intent of the provisions of this Agreement, nor, by trade action, the intent of the provisions of the Articles of Agreement of the International Monetary Fund".

Note Ad Article XV, para. 4: "The word 'frustrate' is intended to indicate, for example, that infringements of the letter of any Article of this Agreement by exchange action shall not be regarded as a violation of that Article if, in practice, there is no appreciable departure from the intent of the Article. Thus, a contracting party which, as part of its exchange control operated in accordance with the Articles of Agreement of the International Monetary Fund, requires payment to be received for its exports in its own currency or in the currency of one or more members of the International Monetary Fund will not thereby be deemed to contravene Article XI or Article XIII. Another example would be that of a contracting party which specifies on an import licence the country from which the goods may be imported, for the purpose not of introducing any additional element of discrimination in its import licensing system but of enforcing permissible exchange controls."

(...)

1-1-2. Current/Capital Account Restrictions

Excerpts From WTO Provisions Relevant to the Relationship between Trade and Finance and Trade and Debt (by WTO Secretariat), WT/WGTDF/W/3, 21 June 2002

² L/5761, adopted on 30 November 1984, 31S/15.

³ C/125 dated 13 March 1984, approved by the Council on 15/16 May 1984 (C/M/178, p. 26), 31S/56, 59, para. 9.

(...)

B. General Agreement on Trade in Services

Article XI

XI:1: "Except under the circumstances envisaged in Article XII, a member shall not apply **restrictions on international transfers and payments** for current transactions relating to its specific commitments".

XI:2: "Nothing in this Agreement shall affect the rights and obligations of the members of the **International Monetary Fund** under the Articles of Agreement of the Fund, including the **use of exchange actions** which are in conformity with the Articles of Agreement, provided that a Member shall not impose restrictions on **any capital transactions** inconsistently with its specific commitments regarding such transactions, except under Article XII or at the request of the Fund".

Article XVI

XVI: footnote 8: "If a Member undertakes a market-access commitment in relation to the supply of a service through the mode of supply referred to in subparagraph 2(a) of Article I and if the cross-border **movement of capital** is an essential part of the service itself, that Member is thereby committed to allow such **movement of capital**. If a member undertakes a market-access commitment in relation to the supply of a service through the mode of supply referred to in subparagraph 2(c) of Article I, it is thereby committed to allow related **transfer of capital** into its territory".

1-2. Trade Restrictions due to Financial Difficulties (Balance-of-Payments (BOP) Restrictions)

Excerpts From WTO Provisions Relevant to the Relationship between Trade and Finance and Trade and Debt (by WTO Secretariat), WT/WGTDF/W/3, 21 June 2002

(...)

IV. Provisions related to the Balance-of-Payments

A. General Agreement on Tariffs and Trade

Article XII

XII:1: "Notwithstanding the provisions of paragraph 1 of Article XI, any contracting party, in order to **safeguard its external financial position** and its **balance-of-payments**, may restrict the quantity or value of merchandise permitted to be imported".

XII:2(a): "Import restrictions instituted, maintained or intensified by a contracting party under this Article shall not exceed those necessary:

(i) to forestall the imminent threat of, or to stop, a serious decline in its **monetary reserves**, or

(ii) in the case of a contracting party with very **low monetary reserves**, to achieve a reasonable rate of increase in its reserves.

* Due regard shall be paid in either case to any special factors which may be affecting the reserves of such contracting party or its **need for reserves**, including, where special external credits or other resources are available to it, the need to provide for the appropriate use of such credits or resources".

(...)

B. General Agreement on Trade in Services

Article XII

XII:1: "In the event of **serious balance-of-payments** and **external financial difficulties** or threat thereof, a Member may adopt or maintain restrictions on trade in services on which it has undertaken specific commitments, including on payments or transfers for transactions related to such commitments. It is recognized that particular pressures on **the balance of payments** of a Member in the process of economic development or economic transition may necessitate the use of restrictions to ensure, inter alia, the maintenance of a level of **financial reserves** adequate for the implementation of its programme of economic development or economic transition".

XII:5(e): "In consultations, all findings of statistical and other facts presented by the International Monetary Fund relating to **foreign exchange, monetary reserves and balance of payments**, shall be accepted and conclusions shall be

based on the assessment by the Fund of the **balance-of-payments and the external financial situation** of the consulting Member".

C. Understanding on the Balance-of-payments Provisions of the General Agreement on Tariffs and Trade 1994

Application of Measures

para. 1: "Members confirm their commitment to announce publicly, as soon as possible, time-schedules for the removal of **restrictive import measures taken for balance-of-payments purposes**. It is understood that such time-schedules may be modified as appropriate to take into account changes in **the balance-of-payments situation**. Whenever a time-schedule is not publicly announced by a Member, that Member shall provide justification as to the reasons therefor".

para. 2: "Members confirm their commitment to give preference to those **measures** which have the least disruptive effect on trade. Such measures (referred to in this Understanding as "price-based measures") shall be understood to include **import surcharges, import deposit requirements or other equivalent trade measures** with an impact on the price of imported goods. It is understood that, notwithstanding the provisions of Article II, **price-based measures taken for balance-of-payments purposes** may be applied by a Member in excess of the duties inscribed in the Schedule of that Member. Furthermore, that Member shall indicate the amount by which the price-based measure exceeds the bound duty clearly and separately under the notification procedures of this Understanding".

para. 3: "Members shall seek to avoid the imposition of **new quantitative restrictions for balance-of-payments purposes** unless, because of a critical balance-of-payments situation, price-based measures cannot arrest a **sharp deterioration in the external payments position**. In those cases in which a Member applies quantitative restrictions, it shall provide justification as to the reasons why price-based measures are not an adequate instrument to deal with the **balance-of-payments situation**. A Member maintaining quantitative restrictions shall indicate in successive consultations the progress made in significantly reducing the incidence and restrictive effect of such measures. It is understood that not more than one type of restrictive import measure taken for balance-of-payments purposes may be applied on the same product".

para. 4: "Members confirm that **restrictive import measures taken for balance-of-payments purposes** may only be applied to control the general level of imports and may not exceed what is necessary to address the **balance-of-payments situation**. In order to minimize any incidental protective effects, a Member shall administer restrictions in a transparent manner. The authorities of the importing Member shall provide adequate justification as to the criteria used to determine which products are subject to restriction. As provided in paragraph 3 of Article XII and paragraph 10 of Article XVIII, Members may, in the case of certain essential products, exclude or limit the application of surcharges applied across the board or other measures applied for balance-of-payments purposes. The term "essential products" shall be understood to mean products which meet

basic consumption needs or which contribute to the Member's effort to improve its **balance-of-payments situation**, such as capital goods or inputs needed for production. In the administration of quantitative restrictions, a Member shall use discretionary licensing only when unavoidable and shall phase it out progressively. Appropriate justification shall be provided as to the criteria used to determine allowable import quantities or values".

Note 1: "Nothing in this understanding is intended to modify the rights and obligations of Members under Articles XII or XVIII:B of GATT 1994. The provisions of Articles XXII and XXIII of GATT 1994 as elaborated and applied by the Dispute Settlement Understanding may be invoked with respect to any matters arising from the application of restrictive import measures taken for **balance-of-payments purposes**".

(...)

II. INSTITUTIONAL DIMENSION: COHERENCE

Excerpts From WTO Provisions Relevant to the Relationship between Trade and Finance and Trade and Debt (by WTO Secretariat), WT/WGTDF/W/3, 21 June 2002

(...)

VIII. Provisions Related to Institutional Issues

A. Declaration on the Contribution of the World Trade Organization to Achieving Greater Coherence in Global Economic Policy-making

para. 2: "Successful cooperation in each area of economic policy contributes to progress in other areas. **Greater exchange rate stability**, based on more orderly underlying economic and financial conditions, should contribute towards the expansion of trade, sustainable growth and development, and the correction of external imbalances. There is also a need for an adequate and timely flow of concessional and non-concessional **financial and real investment resources** to developing countries and for further efforts to address **debt problems**, to help ensure economic growth and development. Trade liberalization forms an increasingly important component in the success of the adjustment programmes that many countries are undertaking, often involving significant transitional social costs. In this connection, Ministers note the role of the World Bank and the IMF in supporting adjustment to trade liberalization, including support to net food-importing developing countries facing short-term costs arising from agricultural trade reforms".

para. 5: "The interlinkages between the different aspects of economic policy require that the international institutions with responsibilities in each of these areas follow consistent and mutually supportive policies. The World Trade Organization should therefore pursue and develop cooperation with the international organizations responsible for **monetary and financial matters**, while respecting the mandate, the confidentiality requirements and the necessary autonomy in decision-making procedures of each institution, and avoiding the imposition on governments of cross-conditionality or additional conditions. Ministers further invite the Director-General of the WTO to review with the Managing Director of the International Monetary Fund and the President of the World Bank, the implications of the WTO's responsibilities for its cooperation with the Bretton Woods institutions, as well as the forms such cooperation might take, with a view to achieving greater coherence in global economic policy-making".

B. Declaration on the Relationship of the World Trade Organization with the International Monetary Fund

para. 1: "Noting the close relationship between the CONTRACTING PARTIES to the GATT 1947 and the **International Monetary Fund**, and the provisions of the GATT 1947 governing that relationship, in particular Article XV of the GATT 1947;"

para. 2: "Recognizing the desire of participants to base the **relationship of the World Trade Organization with the International Monetary Fund**, with regard to the areas covered by the Multilateral Trade Agreements in Annex 1A of the WTO Agreement, on the provisions that have governed the relationship of the CONTRACTING PARTIES to the GATT 1947 with the International Monetary Fund;"

para. 3: "Hereby *reaffirm* that, unless otherwise provided for in the Final Act, the relationship of the WTO with the International Monetary Fund, with regard to the areas covered by the Multilateral Trade Agreements in Annex 1A of the WTO Agreement, will be based on the provisions that have governed the relationship of the CONTRACTING PARTIES to the GATT 1947 with the International Monetary Fund."

III. JURISPRUDENCE

From the European Journal of International Law Website

<http://www.ejil.org/journal/curdevs/sr4.html>

(by Joel Trachtman)

WTO Appellate Body Report: ***India—Quantitative Restrictions on Imports of Agricultural, Textile and Industrial Products***, AB-1999-3, WT/DS90/AB/R (99-1329), adopted by Dispute Settlement Body, 22 September 1999. India, Appellant; United States, Appellee. Division: Ehlermann, El-Naggar and Matsushita. **Major Topics Addressed by Appellate Body: Article XVIII:B, Understanding on the Balance-of-Payments Provisions of the GATT 1994; balance-of-payments justifications; scope of judicial review.**

1. Abstract

This is a case of constitutional significance for the WTO, establishing the wide ambit of “judicial review,” or at least of Dispute Settlement Body jurisdiction, including even matters that are also assigned to more political bodies within the WTO. This decision will have wide ramifications. India argued that jurisdiction over its balance-of-payments based quantitative restrictions was exclusively assigned to the Balance-of-Payments Committee and the General Council of the WTO, constraining the authority of the panel to review the balance-of-payments justification. The Appellate Body rejected this argument, upholding the panel finding that India’s quantitative restrictions violate Article XI of GATT, and are not justified under Article XVIII:11 thereof.

2. Facts

This case concerned quantitative restrictions imposed by India on agricultural, textile and industrial products in 2,714 tariff lines, covering one-fourth of all its tariff lines. India claimed balance-of-payments justifications under Article XVIII:B of GATT 1994.

For the past 50 years, India has maintained quantitative restrictions justified first under Article XII of GATT 1947, and later under Article XVIII:B. Until the establishment of the WTO, India consulted with the GATT 1947 Balance-of-Payments Committee. Thereafter, India consulted with the WTO Committee on Balance-of-Payments Restrictions (the “BOP Committee”). During these consultations, in 1995, the IMF, in an official statement to the BOP Committee, stated that India would be able to phase out its restrictions within two years. In January 1997, the BOP Committee took note of the IMF’s statement that India’s current monetary reserves were not inadequate and that there was no threat of a serious decline in India’s monetary reserves.⁴ These facts serve as a predicate for the application of restrictions under Article XVIII:B. Due to

⁴ Panel Report, *India—Quantitative Restrictions on Imports of Agricultural, Textile and Industrial Products*, WT/DS90/R, 6 April 1999, para. 5.7. The Panel was comprised of Messrs. Celso Lafer, Paul Demaret and Richard Snape

differing views, the BOP Committee achieved no final consensus approving India's plans to phase out its restrictions over 7 years.

3. Analysis of the Appellate Body Report

The original panel determined that it was competent to review the legal status of balance-of-payments measures, and the justification of these measures, to the extent necessary to address claims submitted to it within the scope of its mandate under the Dispute Settlement Understanding ("DSU").⁵ The Appellate Body, examining the basic jurisdictional provisions of the DSU, and of Article XXIII of GATT 1994, agreed.⁶ This reading is confirmed by footnote 1 to the Understanding on Balance-of-Payments Provisions of GATT 1994 (the "BOP Understanding"):

The provisions of Articles XXII and XXIII of GATT 1994 as elaborated and applied by the Dispute Settlement Understanding may be invoked with respect to any matters arising from the application of restrictive import measures taken for balance-of-payment purposes.

The plain language of these provisions made India's argument for a narrow interpretation of "application of restrictive import measures" to exclude the "justification" for these measures very difficult to accept, and it was indeed rejected by the Appellate Body. The Appellate Body read the words "any" and "arising from" in footnote 1 to the BOP Understanding to evidence an intent to grant broad jurisdiction.⁷

The Appellate Body rejected India's reference to the negotiating history of footnote 1, stating that there is no formal record of the negotiations, and, more importantly and properly, that footnote 1 is not ambiguous. The Appellate Body might have supported its position by noting that under article 32 of the Vienna Convention on the Law of Treaties, recourse to preparatory work may be used only in order to confirm the meaning resulting from means of interpretation under article 31 thereof, or to determine the meaning when such interpretation leaves the meaning ambiguous or obscure or leads to a result manifestly absurd or unreasonable. None of these situations existed here, and there was therefore no reason to refer to negotiating history.

India had argued that the panel and Appellate Body should enforce a "principle" of institutional balance, found in municipal constitutions, by creating a kind of "political question doctrine" as known in the U.S., which would be a basis for the "judicial" organs to defer to the more "political" organs. Sometimes these types of devices are known as "passive virtues." The transferability of this type of principle from particular municipal settings to the WTO raises many questions, and the Appellate Body wisely avoided introducing such a principle. Indeed, it found no explicit textual basis for such a principle.

⁵ Panel Report, para. 5.114.

⁶ Appellate Body Report, para. 86.

⁷ Appellate Body Report, paras. 89-93.

The Appellate Body saw no conflict or redundancy between the competence of the BOP Committee and the General Council and the competence of WTO panels, but considered that panels should take into account their deliberations and conclusions.⁸ It concluded that the dispute settlement provisions of the WTO can be invoked with respect to any matters relating to balance-of-payments restrictions.

India also appealed the panel's interpretation of the Note Ad Article XVIII:11 of GATT 1994:

The second sentence in paragraph 11 shall not be interpreted to mean that a contracting party is required to relax or remove restrictions if such relaxation or removal would thereupon produce conditions justifying the intensification or institution, respectively, of restrictions under paragraph 9 of Article XVIII. (emphasis added)

The conditions referenced under paragraph 9 include a threat of a serious decline in monetary reserves, a serious decline in monetary reserves, or inadequate monetary reserves.

Thus, the question related to the temporal and causal link between the relaxation of restrictions and the specified conditions. The panel had required a showing of "more than a mere possibility" that the conditions would occur "immediately after" the removal and that a sufficient causal link be established.⁹ The Appellate Body agreed, finding that this provision requires a "causal link of a certain directness,"¹⁰ interpreting "thereupon" and "immediately" to mean "soon after."¹¹ The Appellate Body found no legal error.

The Appellate Body also approved the (implicit) allocation of the burden of proof regarding this provision to the complainant, the U.S. Importantly, the Appellate Body did not require that the panel explicitly state that the complainant had made a sufficient prima facie case prior to its consideration of the evidence in support of the respondent's defense.

The final issue in this case is one of institutional relations between the WTO and the IMF. India alleged that the panel had failed to make an objective assessment of the matter pursuant to Article 11 of the DSU because it delegated to the IMF its duty to do so. However, Article 13 of the DSU permits the panel to seek information from any source, and Article XV:2 of GATT 1994 calls for full consultation with the IMF on such matters. The Appellate Body found that a "careful reading of the Panel Report makes clear that the Panel did not simply accept the views of the IMF."¹² Therefore, the Appellate Body concluded that the panel made an objective assessment of the matter.

4. Conclusions

⁸ Appellate Body Report, paras. 103-104.

⁹ Panel Report, para. 5.199.

¹⁰ Appellate Body Report, para. 114 (emphasis in original).

¹¹ Appellate Body Report, para. 119.

¹² Appellate Body Report, para. 149.

This is a case of constitutional significance for the WTO, establishing the wide ambit of “judicial review,” or at least of Dispute Settlement Body jurisdiction, including even matters that are also assigned to more political bodies within the WTO. This decision will have wide ramifications.

IV. FINANCIAL CRISIS

Excerpts from WTO, Communication from the OECD, FINANCIAL CRISES: IMPLICATIONS FOR TRADE AND TRADE POLICY, WT/WGTDF/W/7/Add.1, 25 July 2002

(...)

II. The Effects of financial crisis on Trade

2. What would one have expected to happen in the early aftermath of the 1997-98 Asian financial crisis?

- ***Important movements in nominal exchange rates throughout Asia would lead to significant changes in the pattern of relative competitiveness, confusing the price signals on which international trade depends.*** This change would affect both the volume and composition of international trade flows. Depreciating currencies in the Asia region would raise relative import prices, and enhance the competitiveness of domestic producers. In the case of a real depreciation, a shift in domestic (or internal) terms of trade would cause a decline in the demand for imported consumer goods while increasing the demand for intermediate inputs used in the production of traded goods.
- ***In addition, lower spending by consumers and investors in the Asia region would lead to growing excess capacity in many industries, putting downward pressure on prices.*** Thus, even if the volume of exports increased, declining export prices would still reduce export dollar revenues.

3. This textbook response is close to what happened.

- ***Massive import contractions were recorded for the ASEAN 4 (Indonesia, Malaysia, the Philippines and Thailand) and Korea markets.*** First quarter 1998 imports into Thailand and Indonesia declined by respectively, 40 and 36 per cent relative to the first quarter 1997; while Malaysia and the Philippines posted declines of about 19 and 8 per cent, respectively. First quarter 1998 imports into Korea declined by a trade-weighted average of 35 per cent; higher than average proportional declines affected imports from Saudi Arabia, Japan and Singapore; while lower than average declines affected imports originating from Australia and Kuwait.
- ***The delay in any export boom triggered by currency depreciation was indeed realised.*** The value of Indonesia's first quarter 1998 exports contracted by 2.5 per cent relative to their level in the first quarter of 1997, Malaysia's by about 11 per cent and Thailand's by some 5 per cent. Thailand's *volume* of exports grew at an annualised rate of 15 per cent. However, this volume increase was more than fully offset by declining export unit values. The high trade complementarity among ASEAN 4 exports, coupled with their drive to expand exports and market share simultaneously may have contributed to such declines in export prices. Moreover, in

something of a variation to the textbook response, imports of capital goods and intermediate products actually declined, further constraining an export-led recovery.

- ***Meanwhile exports from other parts of Asia remained robust*** – China's and Japan's exports during the first quarter of 1998 grew respectively by 13 and 5 per cent over their first quarter 1997 levels.
- ***The collapse in import demand in the ASEAN 4 plus Korea together with strong export growth in other parts of Asia, and sluggishness in Japan, was accommodated by a decline in intra-Asian trade and an increase in imports in regions outside Asia.*** Comparing European Union imports during the first two months of 1998 with those reported a year earlier for the same period, imports from the Asia region registered major growth rates. EU imports from Korea increased by as much as 28 per cent. Those from the Philippines, Thailand, Chinese Taipei and China registered growth in the 22 to 25 per cent range. Imports from Japan experienced a growth rate of 16 per cent between the two periods, and those from Singapore went up by 20 per cent. United States imports from Thailand increased by 26 per cent during the period January - July 1998 as compared with the same period in 1997. Those originating from the Philippines rose by 18 per cent; imports from Hong Kong and Malaysia increased by 8 and 4 per cent, respectively. In turn, exports from the EU and US experienced a major shift in destination, away from those parts of Asia in crisis and towards one another and other regions, such as Latin America.

4. There was inherent in this situation a clear risk of a protectionist response:

- from the ASEAN 4 and Korea as they were increasingly strained to service mounting external debt;
- from the United States, the European Union and other countries facing a surge in imports from Asia;
- from other regions as they absorbed rising imports from the United States and European Union;
- and for countries highly dependent on commodity exports, as they saw commodity prices fall by as much as 30 per cent.

Admittedly this protectionist risk was tempered in some OECD economies by improved terms of trade owing to lower prices for oil and raw materials, and by lower yields in capital markets. Nevertheless, the risk was there – a risk, in the terminology of the time, characterised as contagion.

V. TRADE, FINANCE AND DEVELOPMENT

*Excerpts from Horst Köhler,
Promoting Sustained Growth and International Financial Stability, April 17, 2002
<http://www.imf.org/external/np/speeches/2002/041702.htm>*

(...)

Better Globalization—More Balance Between Debt and Trade Expansion

7. But the crisis in Argentina and persistent vulnerabilities in a number of countries leave no room for complacency. Argentina in particular has shown that *protracted external borrowing to finance public consumption, without generating sufficient external revenues, breeds disaster.*

8. There is a more general point: *the expansion of global capital markets needs to be better anchored in stronger trade integration and thus growth in debtor countries.* The fact is, however, that since the late 1980s the degree of integration of developing countries as a group into global capital markets (measured by foreign assets and liabilities as a ratio to GDP) doubled, while trade openness (measured as the ratio of exports and imports to GDP) has increased relatively little with the important exception of Asia.

As highlighted by comparative analysis in the Fund's upcoming World Economic Outlook, overall Latin America's external vulnerability is higher than that of other emerging market countries. Why? Latin American emerging markets as a group are relatively more integrated into global capital markets. But, at the same time, they have not managed to raise the share of their exports in GDP in line with their increased external borrowing.

9. If we understand crisis prevention as tackling the causes of crises, we need to view this imbalance as a fundamental problem. I am deeply convinced that we need not less but more integration of economies to foster growth in the global economy, not least to fight world poverty. But if we do not manage a better balance between the opening of capital accounts and the expansion of trade, we may see a cyclical reoccurrence of financial crises.

This means that better trade opportunities for all and the expansion of trade must now become the centerpiece for a strategy to promote sustained global growth and truly shared prosperity. And in this context, I do think the advanced countries have again a main responsibility—in particular by opening up their markets and phasing out the multibillion dollar business of trade distorting subsidies. Essential is leadership to face and withstand special interests of some groups for the benefit of the broad majority of the people in both rich and poor countries. But equally ambitious should be the leaders in the developing countries in getting rid of barriers to trade among themselves.

(...)

Excerpts from
IMF, Effects of Financial Globalization on Developing Countries: Some Empirical Evidence
(by Eswar Prasad et al., Mar. 17, 2003)
<http://www.imf.org/external/np/res/docs/2003/031703.pdf>

I. Overview

(...)

B. Does Financial Globalization Promote Growth in Developing Countries?

11. This section of the paper will summarize the theoretical benefits of financial globalization for economic growth and then review the empirical evidence. Financial globalization could, in principle, help to raise the growth rate in developing countries through a number of channels. Some of these directly affect the determinants of economic growth (augmentation of domestic savings, reduction in the cost of capital, transfer of technology from advanced to developing countries, and development of domestic financial sectors). Indirect channels, which in some cases could be even more important than the direct ones, include increased production specialization due to better risk management, and improvements in both macroeconomic policies and institutions induced by the competitive pressures or the “discipline effect” of globalization.

12. How much of the advertised benefits for economic growth have actually materialized in the developing world? As documented in this paper, the average income per capita for the group of more financially open (developing) economies does grow at a more favorable rate than that of the group of less financially open economies. However, whether this actually reflects a causal relationship and whether this correlation is robust to controlling for other factors remain unresolved questions. The literature on this subject, voluminous as it is, does not present a conclusive picture. A few papers find a positive effect of financial integration on growth. However, the majority find no effect or at best a mixed effect. Thus, an objective reading of the vast research effort to date suggests that there is no strong, robust and uniform support for the theoretical argument that financial globalization *per se* delivers a higher rate of economic growth.

13. Perhaps this is not surprising. As noted by several authors, most of the cross-country differences in per capita incomes stem not from differences in the capital-labor ratio, but from differences in total factor productivity, which could be explained by “soft” factors like governance and rule of law. In this case, while embracing financial globalization may result in higher capital inflows, it is unlikely to cause faster growth by itself. In addition, some of the countries with capital account liberalization have experienced output collapses related to costly banking or currency crises. This is elaborated below. An alternative possibility, as noted earlier, is that financial globalization fosters better institutions and domestic policies but that these indirect channels can not be captured in standard regression frameworks.

14. In short, while financial globalization can, in theory, help to promote economic growth through various channels, there is as yet no robust empirical evidence that this causal relationship is quantitatively very important. This point to an interesting contrast

between financial openness and trade openness, since an overwhelming majority of research papers have found a positive effect of the latter on economic growth.
(...)