The Finance and Trade Nexus: Systemic Challenges

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Statement on behalf of the Third World Network,
Informal Hearings of Civil Society on 'Civil Society Perspectives on the Status of Implementation of the Monterrey Consensus and the Tasks Ahead',
High-Level Dialogue on Financing for Development,
United Nations, New York
22 October 2007

Five years ago, when the Financing for Development (FFD) Conference was held in Monterrey, Mexico, there was considerable momentum generated in which governments pledged to work within a coherent framework led by the United Nations (UN) in addressing the systemic financial, trade and developmental challenges facing countries, especially developing countries.

The Monterrey Consensus of 2002 articulated the international community's recognition of the urgent need to enhance the coherence, governance and consistency of the world's monetary, financial and trading systems to complement national development efforts. Trade, finance and development should be treated in an integrated manner to create and sustain an enabling environment for generating resources for social and economic development. This reflected the increasing integration of domestic economies into the global economic system and growing interdependence among countries as a result of globalization.

Globalization itself was recognized as offering both opportunities as well as challenges, especially for developing countries. State signatories to the Monterrey Consensus pledged to implement policies and measures to make globalization more inclusive and equitable, with such policies and measures formulated and implemented with the full and effective participation of developing countries in order to assist them to respond to these opportunities and challenges.

Five years on, there remains systemic deficiencies within the international trade and financial architecture which continue to undermine efforts to meet the objectives of the Monterrey Consensus to 'eradicate poverty, achieve sustained economic growth and development'. At the same time, there remain little advances towards building 'a fully inclusive and equitable global economic system' as encouraged by the Monterrey agreement. In spite of some incremental reforms to international economic system – such as current proposals towards reforming the governance structures and policy approaches of the international financial institutions – current global arrangements to manage international trade and financial flows remain imbalanced and incoherent, to the detriment of developing countries.

The lack of a focus on development objectives within the trade and financial systems, coupled with the asymmetrical application of international regulatory norms, has meant that current mechanisms used to manage, regulate and coordinate international economic relations have served in many ways to exacerbate rather than redress the economic polarization which has

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accompanied the uneven process of economic globalization. There remains a lack of coherence between multilateral disciplines on trade and finance despite the significant inter-linkages between the two areas and even though this lack of coherence impacts heavily on countries', especially developing countries', capacity to generate financing for development.

The problems of a polarized global economy have been compounded by the unequal participation of states and peoples in the regulatory policies of globalization. International trade and financial regulatory regimes remain primarily constitutive of the interests of powerful developed state actors and influential non-state actors, such as transnational corporations.

Global economic rules are also increasingly developed outside formal inter-state channels, such as through groupings of states such as the G 7, G 10 and the OECD, as well as through quasi-autonomous and private regulatory networks, and the reproduction of transnational business practice. These unofficial mechanisms have significant impact on domestic regulation in a globalized economy but developing country governments and other stakeholders subjected to their regulatory impact often have little or no influence in shaping their rules.

Consequently, there are significant inequalities between states in the way they are constrained by multilateral economic rules. Current global economic arrangements do not provide for a balanced sharing of regulatory obligations – with one set of countries undertaking greater commitments than the other – while the areas subject to regulation also prioritize one set of state interests over the other. This has resulted in the selective application of multilateral economic rules, such as in trade, which facilitate deeper economic integration in areas crucial to the interests and priorities of developed countries while reducing the flexibility for national policies necessary for social and economic development in developing countries.

The choice of areas brought under multilateral economic disciplines and the design of those disciplines thus remain reflective of the interests of industrialized countries over those of emerging markets and other developing countries. They are designed primarily to accommodate the development trajectories of industrial countries and not to develop the productive capacities and social welfare needs of developing countries.

Multilateral trade agreements under the World Trade Organisation (WTO) for example, have extracted concessions from members in areas where industrialized countries have competitive advantage, such as the liberalization of industrial products and service sectors, but have not secured similar commitments in areas of interest to developing countries, such as the liberalization of agricultural markets and reduction of domestic agricultural support in industrialized countries.

Meanwhile, the establishment of strict intellectual property rights regimes through bilateral, regional and multilateral arrangements have been viewed as prioritizing the corporate interests of private economic actors based in industrialized countries, such as pharmaceutical companies, over the developmental interests of developing countries which have been prevented from accessing industrial technology and life-saving medicines among others.

Consequently, many economic sectors in developing countries are facing competition in their domestic markets from foreign imports as a result of rapid import liberalisation at the same time that they face sever constraints to the expansion of their exports, namely continuing protectionist measures in developed countries against products of interest to developing countries, such as domestic subsidies for agricultural producers, tariff peaks and tariff escalation for processed agricultural products and non-tariff barriers. Countries are also facing structural, supply-side constraints, including access to technology, which prevent endogenous productive growth and export capacity. Combined with improperly sequenced import liberalisation, this has detrimental consequences for domestic industries, especially infant industries, especially when trade rules also prevent developing countries from adopting targeted industrial policies to develop these economic sectors.

Therefore, while developing countries are under pressure to liberalise their imports, they cannot determine how fast their exports will grow or how conducive external conditions will be for their exports. With an unfavourable export environment and increased imports, many developing countries face significant trade deficits which affect their overall financing capacity. At the same time, domestic productive capacity is weakened by the shrinkage of policy autonomy which accompanies the aforementioned implementation of trade rules and loan conditionalities, leading to collapse of domestic economic sectors and increasing dependence on imports, subsequently exacerbating their trade imbalances.

Countries with persistent or increasing trade deficits risk getting into balance-of-payments difficulties resulting in financial instability and economic recession which, in turn, leads to indebtedness to external official financing and aid which come with conditionalities attached. These conditionalities, supervised by the international financial institutions, entail the similar path of trade liberalisation and other structural reforms, such as privatisation and deregulation, which exacerbates existing problems faced by developing countries. This vicious cycle is detrimental to countries' capacity to generate sufficient financing to meet their developmental objectives or to escape the poverty trap through mobilising domestic resources and perpetuates a cycle of aid dependency and indebtedness.

The instability generated by current trade rules for developing countries is compounded absence of effective multilateral rules over exchange rates, macroeconomic and other financial policies. International regulation continue to be weak in the areas of international finance where global collective action aimed at minimizing financial contagion and supervising the operations of financial institutions and markets have been limited. In spite of the heightened risks of cross-border financial crises, there has been little global supervision of the domestic financial policies of globally significant economies or cross-border financial flows by non-state financial actors. Again, this is attributed to the reluctance of industrialized economies – and private financial actors based in these countries – to be subjected to multilateral oversight of their financial policies and activities.

The lack of multilateral rules on international monetary and financial flows is a major concern to developing countries because they are highly vulnerable to external financial shocks which can be more damaging than trade shocks. Unpredictable fluctuations in the exchange rate of major currencies predominant in international transactions could alter the trading positions of developing countries and affect the competitiveness of their exports or the value of their imported inputs, leading to balance of payments constraints. Countries may also face balance of payments problems when there are unforeseen interest rate increases on major currencies could also raise debt servicing obligations of countries whose external debt is contracted in those currencies.

Balance of payments problems are also compounded when a financial crisis is generated as a consequence of rapid and improperly managed financial liberalization. The reduction in foreign currency reserves as a result of sudden capital outflows in a financial crisis and the often accompanying currency devaluation limits the ability of countries to finance imports and increases the costs of debt servicing. This is worsened by both the absence of international debt workout mechanisms which enable countries to suspend debt servicing obligations in the face of a crises and the lack of official counter-cyclical financing to offer liquidity to countries facing such balance of payments shocks.

The fall in demand for imports in countries undergoing financial crises impacts on their trading partners as there is a decline in demand for commodities and other industrial inputs in addition to consumables. Global financial stability therefore affects the trade of countries directly involved in financial crisis as well as other countries, ultimately impacting upon the overall growth of global trade. The tightening of global credit could also hamper global trade flows as reduction in economic activity in industrialised countries and emerging markets can lead to a decline in demand for industrial inputs, including commodities, which are the primary exports of many low-income developing countries. All this subsequently impacts on the ability of countries to generate resources to meet their social and economic needs.

The absence of a comprehensive international framework for resolving systemic financial crises is therefore a significant barrier to achieving internationally agreed development targets. In addition to the aforementioned absence of an orderly debt workout mechanism and multilateral regulation of macroeconomic policies and exchange rate regimes, there is also little regulation of new financial instruments, such as hedge funds, whose activities can have global impact. There is also presently no international framework for regulating cross-border capital transactions with clearly defined rights and obligations for source and recipient countries and international debtors and creditors.

Current incremental proposals to reform the institutions at the heart of the international financial architecture, notably the IMF and the World Bank, will do little to redress the systemic financial issues so long as the major developed countries are not bound by the policies of these institutions. Although the reform process underway at the IMF to increase the voice and representation of developing countries in the institution is welcome, the outcomes are unlikely to fundamentally reform the governance structure of the institution to establish sufficient autonomy of the institution from its major shareholders. Neither will they provide a significant shift in its mandate to enable the Fund to exert meaningful control over international capital transactions, supervision of exchange rates or balance of payments and currency positions of non-borrowing member states.

As a result of these continuing problems, the political momentum generated by the Monterrey Conference in 2002 has not been harnessed to address the systemic problems of trade and finance. Reform to the international trade and financial architecture remains contingent upon the political interests and economic priorities of the developed countries even though reform is necessary to prevent large populations around the world from falling into the trap of poverty and economic instability with consequences for social welfare and ecological sustainability.

There needs to be a comprehensive rethinking of the mechanisms of international trade and financial governance beyond a tinkering at the margins if the objectives of Monterrey are to be fulfilled. This includes the design of a multilateral economic governance system which has greater coherence between the trade and financial regimes and better balance of obligations between developed and developing countries cognisant of the different developmental stages of each country. Only in this way can there be effective financing for development.