The Orderly Resolution of Financial Crises – A G20-Led Initiative

How could a Leaders' Level G20 make a difference?

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BRIEFING NOTE

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> ***Coordination of macroeconomic policies is certainly not easy; may be it is impossible. But, in its absence, I suspect nationalistic solutions will be sought – trade barriers, capital controls and dual exchange rates systems. Wars among nations with these weapons are likely to be mutually destructive. Eventually, they too, would evoke agitations for international policy solutions.***
>
> ***James Tobin***

In this paper, which aims to make a contribution to the January 2005 discussions in Mexico City, an experimental approach is put forward. The objectives in taking this somewhat eccentric tack are three:

1.) although there has been little empirical research on the links between financial crises and their impact on trade and trade policy, there is sufficient anecdotal evidence to indicate significant interaction;

2.) trade shifts and trade policy reactions related to financial crises would be proof of their impact on real economies and, if better understood, would strengthen the arsenal of preventive mechanisms available to both the country in crisis and those affected by contagion;

3.) more fully integrating trade issues into the international financial architecture, would increase the institutional reach of alternative state alliances, especially the L20, extending to more trade sensitive groupings such as regional organizations like ASEAN, Mercosur, CAFTA, etc.

Fostering greater understanding of financial crises and their impact in general and augmenting the political weight of developing countries in the design of responsive crisis policymaking are the larger objectives of these comments. Its thesis is that directly relating trade issues to macroeconomic management would advance the efficacy and inclusiveness of the global development agenda. As the issues of process, organization and levels and formality of representation have been ably and proactively dealt with by Ngaire Woods, this contribution is directed at tackling questions related to the L20 agenda as decisions regarding substance will inevitably influence these critical matters facing the group.

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Before we risk a forward look at where the confluence of trade and macroeconomics may be going in the coming years, a look at how developing country trading systems have evolved will help set the stage for how trade may play a role in the contagion so often thought to be the exclusive responsibility of financial markets.

After the collapse of the trading system in the 1930s, developing countries remained at the margins of international commerce for decades. While some Asian nations, notably South Korea, advanced as an export-oriented economy in the 1970s, it was not until the 1990s that attention turned to the protectionist policies, which dominated developing country growth strategies. As the crises of the 1980s *de facto* restructured many emerging market economies, import substitution became unsustainable and, therefore, both pragmatism and evolving policy paradigms led to more open trade relations, less gradually in some countries than others. Other factors, such as their participation in the Uruguay Round and the revival and renovation of pre-existing regional integration agreements, coupled with the increased availability of foreign financing, drew developing countries increasingly towards exporting as a pillar of development.

These efforts were welcomed by the multilateral community which made trade opening, as well as financial market opening, one of the multiple conditionalities of assistance. Despite the reigning conviction that increased trade would follow the prescribed reforms, the results have been disappointing. In Latin America, for example, participation in world trade stood at 4 percent in the mid-1990s, far below the 7.5 percent recorded in the 1960s.

Nonetheless, beyond the larger international picture, there were significant changes. Intra-regional trade, for example, grew overall, although it fluctuated dramatically in response to financial crises and exchange rate imbalances. Moreover, developing countries, like developed nations, engaged energetically in weaving webs of unilateral and regional trade agreements. since 1990 regional trade agreements grew exponentially, now accounting for one-third of world trade.

Two salient facts emerge from this brief overview:

- developing economy trade flows have become far more interdependent among themselves;
- trade patterns between developing and developed countries have proven change resistant , albeit with notable exceptions.

Contrary to broad expectations held at the beginning of the decade as investment flows to developing economies expanded, transnational firms failed to act as motors for increasing either international or regional exports. Add to this the financial restrictions and policy inexperience with regard to supporting export strategies and capabilities among domestic firms, developing country trade participation has been stagnant at best, while unaltered trading patterns (primary products and primary product based) retain the price and volume volatility and vulnerability that compounds balance-of-payments crises when they occur.

It must also be underscored that fundamental to this trade trap is the intransigence of developed countries to tackle their prevailing protectionist, subsidy-dependent trade regimes, even for agricultural products that their economies cannot produce at competitive prices. The current impasse between the European Union and Mercosur is only the latest example of how difficult it is for developing countries to increase market access for foodstuffs, to say nothing of manufactured goods that could directly compete with those of the developed countries.

With this broad-brush panorama in mind, it can be asked: According to historical evidence and economic theory, what responses in the area of trade can be expected from developing countries during a financial meltdown?

a) Policymakers will face a natural temptation to shield their home markets from imports from the crisis-hit country as demand there for local goods is reduced and an exportable surplus become available;
b) Increased support for exports to the crisis-hit country as a reduction in exports will have a negative impact on the trade balance;
c) Increased support for exports to third markets where they compete with goods from the crisis-hit country.

In short, a "beggar thy neighbor" scenario unfolds that is confined to the countries that are, in fact, most exposed to contagion. Despite the lack of systematic research on the links between trade and financial crises, there is evidence that indicates that there has been a progressive reduction in the pace of trade liberalization in the developing world and even, in some cases, a partial reversal. It bears emphasizing that a developing country's ability to meet international obligations and multilateral organization requirements for assistance is dependent, in part, on its capacity to maintain reasonable trade balances.

There is little reason to think that this context will change in the near future. Given the economic and political constraints in the United States and Europe, few are adventuring to forecast any trade breakthroughs. In fact, uncertainties are likely to be greater in the coming two years as exchange rates adjust to the dollar's revaluation and as the outlook for international interest rates continues to signal higher capital costs. In addition, impact of the burgeoning attractions of investing in China, India and other low cost economies are as yet undigested and the impact on other developing countries remains at the level of speculation.

What can be said with absolute certainty is that the lacunae in our knowledge of the relationships between financial crises and trade (read: economic growth) is an area that demands urgent investigation. The following questions might serve as a roadmap for the L20 when it meets in 2006.

- What global macroeconomic instruments and goals must be implemented to sustain trade policy liberalism?
- Could the implementation of some measures implicit on the present trade agenda jeopardize price stability?
- Given that regional trade is growing, does it make sense to think of macroeconomic coordination on the regional or sub-regional level? How would these regional pieces be integrated/coordinated with the global architecture?

- Does global exchange rate uncertainty create incentives for regional monetary policy? Does a turn to regional monetary arrangements place liberalization at risk? Which exchange rate and monetary regimes would better suit the next era of globalization?
- Should the issue of macroeconomic policy coordination be included in trade agendas?
- What is the relationship between capital flows, macroeconomic stability and trade policies?
- Should the agendas on trade negotiations and the issue of volatile capital movements be integrated? [1]

These issues represent a tremendous opportunity for the L20. The contention in these comments is that contagion via trade is systematically underestimated and very poorly understood, leading to the conclusion that the L20 has a significant role to play in furthering analysis and policymaking. Moreover, these questions open a wide venue for the L20, embarking on what should be a nexus of policy innovation that includes the IMF, the World Bank, the regional development banks and the WTO.

As a result of meetings such as this, at which the L20 will further define its role, composition and mandate, the importance of a better understanding of financial crises and their impact on real economies should be a priority.

[1] See Jose Maria Fanelli, *Macroeconomic Regimes and the Trade Agenda in Latin America*, Latin American Trade Network, Working Paper, Number 9, July 2000, for an economic analysis supporting these questions.

As a final comment, the arguments contained in Ngaire Woods' thoughtful paper, "The Orderly Resolution of Financial Crises," receive backing from the thrust of these comments. An effort to link financial crises to trade and drive forward the points made here would require the L20 to convene representation at the highest level. While the participation of Finance Ministry, Economy Ministry and Trade Ministry officials may, in some cases, be necessary and beneficial, the very nature of substantiating the links between trade and financial contagion mandates the convocation of authority above the level of separate interests. Connecting the dots would greatly depend on leadership that can project being above the fray.