23. IMF coverage of trade policy varied widely in range and depth across countries and over time. The basic tenets of the IMF’s approach to trade policy issues are generally well supported by economic analysis (Box 3), but considerable controversy focuses on the application of its approach. This suggests three criteria against which to examine how the Fund carried out its approach: (i) How well thought out was the advice? (ii) Were macroeconomic links clear and considered? (iii) Was advice evenhanded? First for UFR and then for surveillance, we review the broad parameters of the IMF’s work. Thereafter we discuss results of background studies of single countries or issues against these three criteria.

A. Trade Policy Issues in UFR Work

24. Despite a wave of trade liberalization in the late 1980s and early 1990s, trade liberalization still occupied a central spot in IMF-supported programs through 2000. This reflected partially the fact that some countries (especially certain previously centrally planned economies) had not been part of the liberalizing trend, but also the facts that some countries had pursued a measured pace of liberalization and others had stalled in their liberalization. Most countries using IMF resources had some trade reform agenda in place, and conditionality aimed to prevent derailments or quicken the pace of change. In 1996, arrangements (Enhanced Structural Adjustment

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**Box 3. The IMF’s Approach to Trade Protectionism**

Underlying IMF advice on trade policy is rather widely accepted economic analysis. This concerns basic arguments for and against protection of domestic economic activity from foreign competition. Some reasons for protection—to “keep the money at home” or “level the playing field” are unsound. Others with some validity are to favor sectors considered important for national welfare (e.g., agriculture); to develop an infant industry; to improve short-run balance of payments positions; to raise fiscal revenue; or to improve the terms of trade (the optimum tariff argument).

These justifications, however, typically reflect second-best approaches to market failures that are often unrelated to trade. Thus, infant industry protection might look attractive when potentially competitive industries cannot attract private capital, perhaps because capital markets are undeveloped, social benefits are not internalized by the private sector, or external economies of scale exist. In such circumstances, the IMF’s approach—supported by economic analysis—is that the market failure should be corrected by policy that directly targets the source of the problem (the first-best solution). For example, if domestic production is suboptimal, supply conditions should be enhanced; an indirect policy instrument such as an import tariff could support domestic producers, but by encouraging substitution away from imports and thereby causing deadweight losses. Only the optimum tariff argument is a first-best response to a trade-related market failure, but, as a beggar-thy-neighbor policy, it too should be avoided.

These economic arguments are reasonable first principles for the IMF. Also, much empirical evidence points to benefits of low and uniform tariffs for economic efficiency. However, the prevalence of global distortions from trade policies (so that countries formulate trade policy in a second-best world) and the economic success of some countries even with significant protection give critics of rapid liberalization substantial ammunition. Thus, the classic case for low trade barriers alone is an insufficient basis for a constructive trade policy dialogue between country authorities and the IMF. Placing advice on dismantling protectionist barriers in the context of a country’s specific circumstances and constraints is critical for good policy decisions. Much of the criticism of IMF advice on trade policy revolves around this dimension—the focus of this evaluation.
Facility (ESAF), Poverty Reduction and Growth Facility (PRGF), Stand-By, and Extended) had, on average, one-and-a-half conditions (prior action, performance criterion or structural benchmark, excluding the standard continuous performance criterion prohibiting new import restrictions) on trade policy in the initial program (Figure 1). More than half of these conditions pertained to traditional trade policies and more than a third to customs administration, often supported by TA from FAD, which averaged some 20 trade-related TA reports per year during the evaluation period.

25. Conditionality on trade policy fell sharply starting in 2000, when streamlining began. The average number of trade conditions in initial programs fell below one by 2002 and below half by 2007. Conditions on issues other than customs administration virtually disappeared. This drop in trade conditionality was appropriate for several reasons. In many countries, tariff and quota barriers and export subsidies and restrictions had diminished to a point where they were not key impediments to efficiency or macroeconomic stability. Also, many governments asserted that their PTAs had taken some traditional trade policy instruments out of their hands. And active IMF trade conditionality in the late 1990s had raised many legitimate concerns about the IMF’s role in pressing unilateral liberalization, about other countries’ political interference in trade conditionality, and about the trade expertise of IMF staff. Scaling back this relatively heavy-handed approach, therefore, made sense. The rest of this section examines how these issues played out in case studies.

26. In the arrangements examined, trade policy advice was best thought out when staff had a history of analyzing an issue, worked with the World Bank, and built on government commitment to liberalization. In the case studies for this evaluation, staff’s knowledge of trade issues tended to be stronger in low-income than in emerging market countries. In some low-income countries, the IMF had a history of fairly deep engagement in trade policy on which to draw. In Ghana’s 1995 ESAF arrangement, for example, reform of the cocoa sector (including a structural performance criterion on the producer price) built on previous collaboration among the IMF, World Bank, and active government.

7 Background Documents 4 and 5 examine how the IMF handled trade policy in seven low-income countries with PRGF arrangements (Bangladesh, Ghana, Guyana, Kenya, Mozambique, Tanzania, and Vietnam) and five emerging market country arrangements (Brazil, Indonesia, Korea, Turkey, and Ukraine).
CHAPTER 5 • IMF ADVICE ON TRADE POLICY

government, and stakeholders. IMF work there included well-executed studies (evaluating theoretical and practical aspects of cocoa taxation, estimating a model of cocoa supply, and discussing practices in other countries) that helped establish the fiscal effect of reforms in which the authorities had an interest. Similarly in Bangladesh, a tariff reform in the 2003 PRGF arrangement made use of past World Bank studies of the protective regime.

27. In contrast, in countries where staff had not previously been substantially involved in trade policy issues, conditionality tended to be less well thought out. This was the case in some of the emerging market countries, where staff had to switch gears rapidly from surveillance mode, in which trade policy had not been analyzed in detail. Among the five such countries reviewed, staff analysis of trade policy issues was obvious only for Brazil (where trade policy did even not feature in the 1998 program). In Indonesia and Korea, where trade policy conditionality was extensive, little evidence of deep familiarity with the issues came to light. In both these countries, medium-term trade liberalization programs were in train, and conditionality established more ambitious targets for tariff reduction—a development the authorities interviewed by the evaluation team viewed as unnecessary, though not particularly problematic. More questionable were conditions in the 1997 Indonesia program to dismantle state trading monopolies and lower export taxes. These were hastily prepared with minimal input from the World Bank and without enough attention to ensuring that new distribution channels, taxes, or institutions were in place.

28. Marshalling trade expertise from the World Bank met with mixed success. In the emerging markets examined, the World Bank was typically not active enough in trade policy to contribute significantly to program design. The exception was Indonesia, but, there, differences between Bank and Fund staff views on governance problems limited the Bank’s role. In some low-income countries covered, Fund-Bank cooperation was stronger—ranging from sector-specific work in Ghana to Bank staff effectively taking control of trade policy issues in Bangladesh. Fund-Bank interaction in other low-income countries was not as obviously systematic. In some cases, IMF staff saw this as a result of the Bank’s focus on other issues. And in Mozambique, a potential conflict of interest (the International Finance Corporation had a stake in one of the sugar refiners) may have explained the lack of Bank support for the IMF’s position on removing the sugar tariff.

29. Some missions responded to critics’ suggestions that the IMF present options for reforms, but episodes of single issues escalating to unwarranted importance occurred. Commitments or plans (such as to lower average or maximum tariff rates) were usually general enough to allow various configurations of tariff schedule changes to fulfill them. For some reforms (such as in Ghana’s cocoa sector), options for how to proceed were discussed with the officials, and in Mozambique, impasses on two trade issues (taxation of raw cashew exports and tariffs on sugar imports) were addressed by commissioning outside studies. Yet, incidences of a hardening of staff positions on a single issue of questionable macroeconomic relevance still occurred. For example, in 2003, IMF insistence that the Ghanaian government reverse a parliamentary decision to raise the poultry tariff received much adverse publicity and did not reflect a deep consideration of the macroeconomic importance or merits of the issue (Box 3, Background Document 4). Less controversial from a substantive viewpoint, but still raising the profile of an essentially microeconomic issue, was the IMF’s insistence on eliminating export taxes on raw sunflower seeds in Ukraine. Reasons for these incidents varied from misjudgments on the importance of the issue (in Ghana) to efforts to drive home a broad point on relinquishing state control favoring special interests (in Ukraine).

30. Data deficiencies at times compromised the quality of trade policy analysis. The most obvious example of this problem in the case studies was in Guyana where staff’s understanding of the degree of protection in the 1990s turned out to be based on severely deficient data, and confusion about what steps the authorities had taken in the tariff reduction program led to a misspecified performance criterion. More broadly, experience with the IMF’s Trade Restrictiveness Index (TRI) was problematic. This index provides a simple summary measure of restrictiveness and is useful for understanding changes in a country’s trade policy stance. In 1998 PDR (based on Board recommendations) asked staff to provide TRI targets at the outset of all medium-term arrangements. Yet the TRI was misused as a stand-alone measure, and in 2005 management instructed staff to stop reporting TRIs. This reversal had merit, insofar as the TRI is a simply-conceived measure that does not capture many dimensions of a country’s protective structure. But efforts to build an alternative index were abandoned over methodological disputes, leaving staff with no consistent way to track the stance of tariff and quota policies.8

8 A background paper by Krishna, “The IMF’s Trade Restrictiveness Index” (see www.ieo-imf.org) assesses the TRI and alternative measures.
31. Explicit assessments of the expected macroeconomic effects of trade policy changes were wanting. Despite PDR guidelines prescribing such assessments, only a few program documents reviewed provided quantified analyses of the effects of trade policy on growth or the balance of payments. This may reflect the scarcity, even in the literature, of solid methodologies for estimating these effects, despite considerable agreement on the medium- to long-term direction of the effects. But the lack of an explanation of expected macroeconomic effects begs the question of what was the link between (in some cases extensive) trade policy conditionalities and causes of the crises. This was especially true for some of the emerging market case studies, where IMF arrangements were responses to capital account crises. In the PRGF cases, changes in trade restrictions were often part of a broader tax reform designed to reduce dependence on trade taxation. In these countries, some analyses reflected deep work on fiscal effects of trade policy changes, an area in which FAD has made substantial contributions. Still, a recurring problem (e.g., in Bangladesh and Tanzania) was underestimating negative revenue effects from tariff cuts.

32. Trade policy conditionality was not evenly handled in the cases evaluated, at times due to political interference. In the PRGF countries covered, treatment of trade issues was reasonably similar across countries with comparable degrees of restrictiveness and dependence on trade. Bangladesh stands out as having had less conditionality on trade policy, though probably because the Bank took the lead on this issue. But in the emerging markets examined, the treatment was uneven. These countries all had moderately restrictive trade regimes and, except in Korea, similar dependence on trade. But conditionality on trade policy was extensive in Indonesia and Korea, absent in Brazil and Turkey, and episodic in Ukraine. Moreover, in Korea and Indonesia, but not Brazil, arrangements had commitments to bind measures agreed with the WTO to liberalize trade in financial services; Brazil has yet to ratify its commitments under the General Agreement on Trade in Services (GATS) financial services protocol. With no obvious indication that trade reforms were critical to addressing the causes of the capital account crises in these countries, political pressures on IMF management from trade partners or competitors appeared to play a role in the disparities. The result was not always substantive flaws in the policies supported, but certainly diminished credibility of IMF independence.

33. The IMF’s retreat from trade policy conditionality has merit, given the conceptual and practical problems just enumerated. But the accompanying drop in trade policy analysis left gaps. All the emerging market countries evaluated except Turkey had surveillance-only status by 2004. After the arrangements, the IMF did little in-depth work on trade policy in these countries, despite their growing role in world trade. In the PRGF arrangements examined, trade policy conditionality was virtually off the table (except on customs administration) by the end of the evaluation period. Recent IMF involvement in trade policy issues was quite uneven (periodic in Bangladesh, Kenya, and Vietnam and sporadic in the others). Interviews with IMF staff in the African Department suggest that this was as much because PTAs were increasingly formulating trade policies as because conditionality had tapered off. In interviews with the evaluation team, some officials regretted gaps left by the drop in IMF work on trade policy issues: some felt, for example, that IMF views on the European Union’s (EU) economic partnership agreements would have been useful for understanding micro-macro linkages in issues under negotiation.

B. Trade Policy Issues in Surveillance

34. Surveillance over trade policy was largely handled in bilateral consultations. Whereas the Fund’s World Economic Outlook (WEO) during the 15 or so years up to 2002 typically devoted a chapter to trade policy every few years, no such chapter has appeared since 2002. As Regional Economic Outlooks (REOs) took their place in the battery of staff work, only two early ones (sub-Saharan Africa 2005 and Asia-Pacific 2005) devoted chapters to trade policy. Thus despite continuing work on trade policy in RES (albeit diminishing as a share of all work), most recent surveillance work on trade policy has been done in area departments and FAD (in connection with TA and trade tax issues) and has not found an outlet in multilateral surveillance. Given the growing multilateral dimensions of trade policy issues—especially PTAs—this was a missed opportunity for surveillance.

35. Broad measures point to roughly steady coverage of trade policy issues in bilateral surveillance but decreasing analytical depth behind the views expressed. About 70 percent of Article IV reports in the three years reviewed in depth for this evaluation (1996, 2000, and 2006) had views on trade policy. Behind these averages, changes occurred.

- The trade policy issues on which consultations focused changed (Figure 2). Views expressed in staff reports shifted from traditional trade policies (tariffs and nontariff restrictions on merchandise trade) toward PTAs, trade in services and preference erosion. The shift was appropriate as new trade policy issues became important.
The share of staff reports where views were expressed on trade policy and obviously backed by any analysis (from inside or outside the IMF) or description dropped from about 75 percent in 1996 to 25 percent in 2006 (Figure 2). Views not backed by obvious analysis or description of trade policy fit various characterizations: advice that reflected academic consensus on an issue, but little specificity to the country concerned; advice so general that its content was minimal; or advice that missed opportunities for a more persuasive approach.

The amount of in-depth work for surveillance varied widely over time. During 1996–2007, the number of background papers containing analysis (that is, more than simple description) of trade policy—the simplest measure of depth—varied between 23 and 4 per year (Figure 4). Over the evaluation period, staff carried out multiple analyses of trade policy for some countries, but none for many others. Thus for about 20 percent of advanced countries and 50 percent of low-income countries, no analysis of a trade policy issue appeared in any background paper for the country or for a regional arrangement to which the country belonged during 1996–2007.
36. Given these trends, the case studies of surveillance focused on two types of work: that on three advanced countries (two systemically important countries—Japan and the United States—and Norway, a smaller country with very high agricultural protection and many PTAs) and that on two new trade policy issues (PTAs and trade in financial services).

**Bilateral surveillance in advanced countries**

37. Though two key trade policy issues—agricultural protection and PTAs—were common to the three countries examined, the depth of coverage varied substantially. Distortions in agriculture, which had implications for other food producers and domestic efficiency, were criticized strongly in Article IV consultations in all three countries, but supporting background work varied widely. In 2001–02 for the United States (during and immediately after the debate on the pivotal 2002 Farm Bill) and 2005 for Japan, staff views were backed by good analytical or empirical work; officials interviewed for the evaluation acknowledged the quality of the work. In contrast, in Norway no background work

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**Figure 3. Staff Background Papers with Trade Policy Analysis, 1996–2007**

- **Bilateral surveillance**
- **Surveillance of regions and currency unions**

**Figure 4. Distribution of Background Papers with Trade Policy Analysis, 1996–2007**

- **High-income**
- **Middle-income**
- **Low-income**

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9 Background Document 6 presents case studies underlying this section.
lent depth to staff views. Staff reports for Norway criticized high agricultural protection (especially for its harmful effects on developing countries), but the officials did not regard the issue as a significant part of the consultations. The treatment of PTAs was also uneven. While the North American Free Trade Agreement (NAFTA) was frequently in the focus of U.S. surveillance through 2004 (with good analytical background work), in neither Japan (where PTAs have become important rather recently) nor Norway (which is party to many PTAs, mainly through the European Free Trade Association) have background papers been produced.

38. During the 1990s, Article IV staff reports for the United States and Japan provided a record of ongoing trade policy changes. Early in the period, U.S. selected issues papers (SIPs) catalogued the use of antidumping or countervailing duties in an effort to put pressure on the authorities to resist protectionist measures following the Asia crisis devaluations even when such measures did not violate WTO obligations. For Japan, SIPs through 1997 detailed changes in trade policies in the preceding year and generally urged a liberal stance. The discontinuation of these descriptions removed a rather tedious part of the IMF’s work at a time when the WTO’s TPRs were covering much the same ground.

39. After 2004 for the United States and more recently for Japan and Norway, consultations backed off trade issues. For the United States, staff reports and Board summings up became increasingly pro forma in calling for liberal trade policies and support for the Doha Round. Macroeconomic effects of two Congressional bills—the 2008 Food Conservation and Energy Bill (which included provisions expected to raise agricultural subsidy payments) and the Energy Independence and Security Act of 2007 (which raised subsidies for ethanol production and many believe contributed to food price increases)—were not addressed in staff reports. In explaining this change in approach, staff pointed not to any perception that the macroeconomic importance of trade policies had diminished, but rather to the pressure to focus on financial issues and meet word count limits in staff reports.

Surveillance of PTA issues

40. The unevenness in the treatment of PTAs in advanced countries is characteristic of surveillance of PTAs across regions and income levels. The incidence of in-depth views in staff reports on PTAs rose from virtually nil in 1996 to about 10 percent of consultations in 2006, but this was still a small share for an issue that dominated trade policy changes. Views in staff reports ranged from support for to caution about a country’s involvement in PTAs, often with no apparent justification for the differing perspectives. Three factors seem to explain these characteristics of the coverage.

- Except in large countries, PTAs entail some loss of national autonomy over trade policies. The IMF has a framework for consultation with four currency unions, but no modalities for surveillance over trade policies of PTAs. In bilateral consultations, staff claimed, national authorities often fence off policies that fall within the purview of PTAs, and staff were reluctant to inject themselves in bilateral or regional affairs. Thus, while the volume of analytical and empirical work on PTAs in RES and area departments suggests researchers identified important macroeconomic or systemic effects of PTAs, the uptake in staff reports, let alone WEOs and REOs, was tepid.

- Weak data, not just in the IMF but universally, on many aspects of PTAs (trade flows through PTAs, tariff rates in PTAs, specifications of rules of origin, and even a precise roadmap of PTA membership) were an impediment.

- Gaps in Board guidance on the IMF’s approach to PTAs seem to have discouraged staff interest in PTAs. Moving beyond the simple assertion in 1994 that most-favored-nation liberalization working toward global free trade is the first-best policy, the Board in 1999 supported a general definition of best practices for the design and implementation of PTAs. But these broad parameters left questions about the role the IMF should play in PTA issues, and efforts to address those questions in a 2006 Board seminar were not fully successful.

Thus, gaps in the guidance, together with the difficulties of addressing an issue that is politically sensitive and logistically complicated, meant that staff analysis of PTAs found less reflection in the IMF’s operational work than it could or should have.

41. In what sorts of PTA issues might the IMF have played a larger role? The IMF made good contributions to assessing trade creation and diversion (e.g., for NAFTA and the Central America-Dominican Republic Free Trade Agreement (CAFTA-DR)), the costs for developing countries of preference erosion (e.g., for the Caribbean region), and fiscal effects of PTAs (e.g., for CAFTA-DR). But these have been episodic, and (particularly given limitations on the WTO’s role) light IMF involvement in other PTA issues meant that macro-critical issues often went unaddressed. The Fund should have more uniformly addressed how the proliferation of PTAs could affect

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the scope for protectionism and how specifications of rules of origin or membership in multiple PTAs could affect competitiveness and growth. At a regional level, the limited analysis of the EU’s approach to negotiating economic partnership agreements—an issue with macro implications for many African countries—was regrettable. And given that PTAs often brought deep, behind-the-border integration, the IMF should have been involved in anticipating how provisions in these agreements affected competitiveness as well as economic and financial stability.

**Surveillance of trade in financial services**

42. Trade in financial services is central to IMF concerns about financial stability, but has not received enough direct attention. In its 2005 review of the IMF’s role in trade policy, the Board explicitly encouraged staff to become more involved in this issue, but gave no guidance on objectives or a conceptual framework. With little follow-up from either the Board or management, more than half of staff responding to the IEO’s survey indicated that they were not aware of this guidance. Of those who were, about half said they had responded actively or moderately.

43. Evaluating work on trade in financial services is difficult because the parameters of the issue are tough to pin down. Discussions with staff revealed differing views about whether the crux of the issue was trade flows per se, liberalization of foreign direct investment (needed for financial institutions to establish bricks-and-mortar presence in another country), restrictions on profit remittances, or financial supervision (including home-host regulatory issues). Some staff felt they had addressed many of these issues in Financial Sector Assessment Program (FSAP) or surveillance work, even if they were not coordinated under the rubric of trade in financial services. A serious impediment to focused work on trade in financial services is the virtual absence of measures of the degree of restrictiveness of countries’ financial services sectors.

44. Those staff reports that clearly sought to address policies affecting trade in financial services tended to urge greater openness almost indiscriminately. Typically, staff advocated greater openness (eliminating explicit barriers to foreign entry, but also urging sale of government-owned banks or shares in banks) as a means to increase domestic bank capital, reduce concentration of ownership, sharpen competition and/or attract risk management skills. Rarely did staff reports or Board summings up call attention to trade in financial services issues arising in countries’ WTO or PTA negotiations. Seldom did they directly assess risks, costs, or benefits of opening to trade in financial services. Notable exceptions were in a 2006 SIP on the role of South African banks in neighboring countries and a 2000 SIP on Cambodia’s WTO accession negotiations.

45. In contrast, the IMF’s *Global Financial Stability Report (GFSR)* and its predecessor the *International Capital Markets Report (ICMR)* kept trade in financial services issues in view, albeit sporadically. On occasion, chapters were devoted to the changing landscape of trade in financial services and its implications for financial stability. In 2000 and 2007, chapters reviewed the risks and benefits of cross-border bank ownership, providing a useful set of benchmarks against which bilateral surveillance or FSAP teams could have evaluated experiences with opening financial markets in individual countries.

46. Greater involvement in trade in financial services would require more attention to issues arising in WTO accession or PTA negotiations. The evaluation team heard support for such engagement from several sources. Some country officials said that they had struggled to understand the macroeconomic and financial implications of issues coming up in such negotiations. WTO staff and committee members acknowledged that the dynamics of trade negotiations do not lend themselves to the kind of oversight that the IMF could provide of related financial issues. Some institutional cooperation on this issue occurred (a 2003 PDR/Monetary and Financial Systems Department seminar on financial sector implications of the GATS negotiations brought together IMF, European Commission, and U.S. Federal Reserve staff) but with little effect.

**Trade finance**

47. Trade finance received regrettably little attention in the IMF during the evaluation period. This topic is beyond the scope of the evaluation, but, given its current importance and concerns some officials voiced to the evaluation team, it warrants mention. The history is short. In the years after the outbreak of the Asia crises, the WTO Director General approached the IMF with ideas for addressing trade finance vulnerabilities. Independently, in 2003, PDR organized a conference (with participation from the private sector and international organizations) and

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11 A background paper by Stern, “Trade in Financial Services: Has the IMF Been Involved Constructively?” (see www.ieo-imf.org) examines IMF work on trade in financial services.

12 Since the evaluation period, the Strategy, Policy, and Review Department started a project on this issue.
identified possible actions involving public and private sectors with a supporting role for the IMF. In response to staff’s presentation of conclusions, the Board supported a rather hands-off role for the IMF. These efforts, which paralleled initiatives at the WTO, produced little concrete action, partly because other players stepped in to fill the gap. Nor were IMF staff active in considering trade finance issues in surveillance. Present setbacks to trade finance speak to the inadequacy of the response.