Staff Response to Independent Evaluation Office Evaluation of IMF Involvement in International Trade Policy Issues

Executive Board Meeting
June 8, 2009

Key Points

- We welcome the IEO's perspective on the role of trade in the Fund, including the recognition that trade policies can strongly influence macroeconomic stability. Staff agree on the need to prioritize trade work, while remaining within the existing resource envelope.
- We agree with the focus on financial services and preferential trade agreements, and the need to ensure due attention to farm and other systemically-important trade policies in major countries.
- Staff agree that the Fund needs to have some dedicated expertise on trade issues, though not a stand-alone division on trade policy.

1. This IEO Evaluation presents a useful assessment of the Fund's involvement in trade policy and provides constructive ideas for its future evolution. The Fund's overall mission requires that it address certain aspects of trade policy, including those that significantly influence external stability, yet we must be mindful of overall constraints. In this context, we see the recommendations as useful in contributing to a discussion on priorities for trade work within the Fund, rather than expanding that work.

2. Resources devoted to trade have declined. The Evaluation could, however, have conveyed more clearly that success in opening trade regimes globally made a reduction in staff resources for trade desirable. Nevertheless, as international economic integration has deepened the macro-critical trade issues facing staff have also tended to change, and there is a need to develop guidance for new issues such as preferential trade agreements (PTAs) and financial services.

Comments on IEO Recommendations

3. *Board guidance*. Periodic Board guidance on trade policies would help to define the parameters of trade work in ways that best support the Fund's broader mission. We agree that such discussions should be more focused than the 1994 Comprehensive Trade Paper. In line with the cycle for other policy reviews, this could be done at five-year intervals.

4. *Trade policy in Fund-supported programs*. Members experiencing balance of payments needs can face protectionist pressures, and an advisory role may be appropriate during Fund-supported programs. Guided by Article I(v), the emphasis should be on avoiding the resort to trade restrictive measures: trade liberalization should be promoted actively only where judged necessary for program objectives. Staff considers that cross-country monitoring of trade finance developments, including through close contact with market participants and trade finance experts in other institutions, is normally adequate, although additional attention to trade finance is appropriate in periods of financial market stress, such as the current crisis.

5. *Surveillance: PTAs*. There is scope for additional guidance to staff on the role and approach of the IMF in PTAs. This should not expand the mandate by involving staff in detailed assessments of individual PTAs. Rather, considering the Fund's broader objectives and aware of the work done in other multilateral organizations, the guidance should identify particular aspects of PTAs such as fiscal effects and the impact on investment flows in which the Fund's broader mission implies an interest.

6. *Surveillance over trade policies: trade in financial services*. Considering the importance of financial services trade in financial stability, there is also scope for guidance on the IMF role and the modalities for staff work. This role might appropriately stress the links between trade in financial services; the (international and domestic) regulatory environ-

ment, including of the WTO; and capital account liberalization. It may be important to develop in a very few staff the appropriate specialized expertise.

7. *Trade policy in multilateral and regional surveillance*. We agree that there should be occasional trade-policy-related pieces in existing surveillance vehicles such as the *WEO* and *REOs*, to place these issues in a regional and global context. Like the IEO, we see potential economies of scale in orienting these pieces toward helping IMF staff teams sharpen views on trade issues of macroeconomic significance. This could also help to meet the IEO's objectives regarding outreach and the balance of trade policy issues across the Fund membership.

8. *Trade policy advice across the Fund membership*. The IEO's recommendation here lines up well with existing guidance following the Review of Fund Work on Trade (SM/05/47). On that occasion, "Directors considered that it would be useful to extend the staff's analysis of spillover effects of the trade policies of key industrial countries to cover also the trade policies of larger middle-income countries…." (BUFF/05/45). In the event, the anticipated extension of trade policy spillovers to a few larger middle-income countries has not occurred. The diminished frequency and depth of coverage in key industrial countries has reflected shorter and more focused staff reports, uncertainty as to when a "spillover" warrants attention, and, more recently, a decline in overall staff resources and the urgency of crisis-related work. Staff agree that more consistent attention be given to the regional and global effects of trade policies in systemically important countries. For the relatively few countries concerned, in most cases trade policy spillovers could be addressed at two to three year intervals. To use staff and travel resources most efficiently, we would explore carrying out much of this work in Geneva, where all large members have mid- and high-level trade officials, with area department staff following up with capital-based officials.

9. *Outreach*. Staff supports the objectives of this set of recommendations. We agree particularly with the way in which the IEO elaborates the recommendation in the context of PTAs. Addressing other IEO recommendations (such as on board guidance and multilateral and regional surveillance vehicles) would in staff's view go far toward enhancing outreach, and greater selectivity and clearer priorities in trade work would facilitate also greater outreach in the selected areas. Exploring alternative modalities for trade work may allow for doing this work roughly within the existing envelope of trade-policy-related resources.

10. *Expertise and organization*. We agree that a certain level of expertise on trade policy is needed inside the Fund, particularly as the focus shifts from conventional trade policies to newer, more complex areas. However, given the larger division size following the Fund's recent refocusing, this may not be best achieved in a stand-alone division. Regardless of the division structure, we believe that implementing other IEO recommendations would provide needed exposure to this work and help to draw and sustain the required expertise. Staff would be open to exploring other modalities if these could improve the quality and efficiency of our trade work.

11. Data on trade policies are important, but information on trade policies need not come exclusively from the Bretton Woods institutions. The quality and accessibility of trade policy information from the WTO and other institutions has greatly improved over the last two decades. Also, compiling data has often considerable resource costs. As the Evaluation notes, the World Bank has had considerable difficulty in keeping its Trade Restrictiveness Index (TRI) up to date even with its much larger resource envelope, and we doubt that Fund staff could do much to expedite the TRI.

12. Staff share the IEO's view that institutional cooperation has been generally effective, particularly at the informal level and among management teams. Much of the informal cooperation with the WTO involved the Office in Geneva, and with its closure in November 2008 staff are mindful of the need to sustain the frequency and quality of institutional cooperation. Occasional regular or formal meetings on trade with counterparts in other multilateral economic institutions may have important benefits. Such meetings might be most effective at staff levels and be used to set an agenda for and follow up on practical issues of common importance to the institutions.

Appendix: Country-Specific Comments and Factual Corrections

Country-specific comments

Japan

Paragraph 37 argues that Article IV consultations with Japan after 2005 have not included background papers on the issue of PTAs. We would emphasize, however, that staff's 2007 report on Japan makes the point (page 26, paras. 32 and 34) that to enhance the benefits of PTAs, Japan's network of bilateral EPAs should work effectively on a regional basis, such as

through regional cumulation of origin and low and secure MFN tariffs, and recommended a reduction in agricultural protection. To provide supporting detail, staff included an annex (page 37) specifically on issues regarding Japan's economic partnership agreements.

Indonesia

Paragraph 32 of the report notes that "*without obvious indications 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/competitors appeared to play a role.*" Staff would emphasize, however, that in the background study on Indonesia, the IEO clearly lays out the case for trade reform in the Indonesia program as being "essential for improving productivity, efficiency, and economic governance" (para. 6).

Vietnam

Paragraph 111 of the background document suggests that the liberalization of financial services in Vietnam increased risks and created instability in the banking sector. Staff would qualify this with three points. First, foreign banks continue to have only a limited presence in Vietnam, mainly operating as bank branches, with three foreign-owned subsidiaries having only recently started to operate. Second, as noted in the 2008 Article IV consultation, "*some joint-stock banks (JSBs) have benefited from investment and knowledge transfer by major foreign banks in recent years*." Finally, the statement in the background document that "*The liberalization of foreign entry into the banking sector in 2007 brought a flood of domestic and foreign applications for banking . . . concerned about the possible impact on banking soundness, the central bank tightened the criteria for granting new licenses in August 2008*" is misleading. In fact, most of the applications for banking licenses were from domestic entities, while rapid credit growth was fueled by massive capital inflows. The central bank's response—tightening the licensing criteria—was not aimed at foreign banks, but rather at domestic banks, in particular the conversion of rural banks to urban JSBs as well as attempts by state-owned enterprises to establish their own banks.

Turkey

Paragraph 32 uses the example of Turkey to support the claim of uneven treatment on trade policy conditionality. It should be emphasized, however, that the Turkish economy at the end of the 1990s was burdened with many inefficiencies, and program conditionality in 1999 focused on fiscal sustainability—which was at the core of Turkey's history of macroeconomic instability—and those issues most related to it. Furthermore, it is important to note that the World Bank took the lead on agriculture and trade issues at that time.

Tanzania

Regarding paragraph 22 of Background Document 4 staff would emphasize that since 2007 wide-ranging customs reform initiatives have been implemented, including the East African Community customs union protocols and common external tariff; improved trade facilitation; automation; and integration of customs administration and destination inspection processes.

Factual corrections

In Background Document 2, the extent to which the WTO is required to consult the Fund on issues within Fund jurisdiction, including under Article XV of GATT, is somewhat misleading. Specifically, the role assigned to the Fund by the WTO Agreements is more dispositive than suggested in paragraphs 4 and 8 of Background Document 2. GATT Article XV provides that the WTO "*shall accept* (emphasis added) the determination of the Fund as to whether action by a [member] in exchange matters is in accordance with the Articles of Agreement of the IMF." In this regard, contrary to what is suggested in paragraph 4 of Background Document 2, the WTO is *required* to, not "expected" to, defer to the Fund's findings on the consistency of a member's action in exchange matters with the Articles of Agreement. Similarly, in paragraph 8 of Background Document 2, a panel is *clearly required* to receive and treat as authoritative the Fund's findings on the consistency of a member's actions with the Articles of Agreement.

The main report contains several incorrect statements concerning the new policy on structural conditionality. In particular, paragraph 15 incorrectly states that the IMF is retreating from structural conditionality. Rather, the IMF is changing the modalities for monitoring progress in the area of structural reform in a review-based framework.

The main report and Background Document 1 draw a distinction between a "*passive*" and an "*active*" role in the surveillance of trade policy issues. Staff would like to clarify that the Fund has not viewed its surveillance mandate in a manner that distinguishes a passive and an active role.

Paragraph 43 of the main report argues that "*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.*" We do not disagree, but it's worthwhile noting that the IMF's *Annual Report on Exchange Arrangements and Exchange Restrictions*

(AREAER) database does include useful information on three modes of trade in financial services, namely: purchase abroad; cross-border provision of services; and commercial presence.

The report does not mention the IMF's cooperation with a number of other relevant bodies, including, for example, the World Customs Organization (WCO).

The reference for the *Review of Fund Work on Trade,* SM/05/47 (Washington: International Monetary Fund) is incorrect in Background Document 1.

Paragraph 6 of Background Document 2 states that, according to the Reference Note on WTO-Consistency, Fund staff could not, in the context of a comprehensive tax reform, ask a country to increase some tariffs above their WTO bindings. This statement appears to go further than the Reference Note, which stated that Fund staff should explore alternatives with authorities for not increasing tariffs above their WTO bindings and that, if this is unavoidable, the staff should advise the authorities to consult with the WTO under the relevant provisions to seek the requisite waiver.

Paragraph 17 of Background Document 2 incorrectly mixes staff policy advice on surcharges with the Fund's institutional role in WTO BPC consultations. On the latter, the WTO Agreements do not call on the Fund for trade policy advice.

In paragraph 32 and Box 10 of Background Document 2, the discussion misses the key practical benefit of the TIM, the deviation feature (under which augmentation decisions can be expedited). In Box 10, the "*policy adjustment endorsed by the staff*" seems to refer to the TIM qualifying event. That qualifying event was not CAFTA-DR, but the WTO ATC.

Paragraph 15 of Background Document 3 is somewhat outdated as it does not reflect the Board's more recent discussion of revenue replacement issues in 2005, in the context of FAD's background paper on dealing with the revenue consequences of trade liberalization.

Paragraph 128 of Background Document 4 referencing the Baunsgaard-Keen paper should be qualified. As other later work has stressed, country experience has varied widely, and some low-income countries have a good revenue replacement performance.