INTERNATIONAL MONETARY FUND

Fund Support for Trade-Related Balance of Payments Adjustments

Prepared by the Policy Development and Review Department

(In consultation with other Departments)

Approved by Mark Allen

February 27, 2004

Text Boxes

Tables

Executive Summary

Multilateral trade liberalization has been a major contributor to the world economy's unprecedented growth over the past half century. In tackling remaining restrictions on trade, the WTO's Doha Development Agenda has the potential to benefit all countries. While overwhelmingly positive in its impact over time, opening the world trading environment further would require countries to adjust. Concerns over the costs of adjustment, in particular among developing countries, are further complicating the WTO negotiations.

The proposed IMF Trade Integration Mechanism (TIM) aims to mitigate concerns that implementation of WTO agreements might give rise to temporary balance of payments shortfalls. A balance of payments need might result from the erosion of tariff preferences in important export markets, adverse changes in food terms of trade, or the expiration (in 2005) of quotas under the WTO's textiles agreement. Shortfalls are unlikely to be large for most countries, and would eventually be dominated by the positive impact of more open trade. Nevertheless, they could be significant in the short run for some countries.

The proposed TIM details how the Fund would provide access to its resources to meet a balance of payments need associated with trade-related adjustments. In particular, the IMF would:

- stand ready to discuss with countries facing such balance of payments shortfalls, new arrangements within its existing lending facilities (i.e., upper credit tranches, the Extended Fund Facility (EFF), or the Poverty Reduction and Growth Facility (PRGF));
- take into account the anticipated impact of the trade adjustment on the member's balance of payments in determining the appropriate size of access under both new and existing arrangements (the "baseline feature"); and
- be prepared to augment arrangements under simplified procedures if the actual balance of payments effect turns out to be larger than anticipated (the "deviation feature").

The TIM is in line with existing Fund policy for balance of payment support and with the purpose of the Fund as set out in Article 1 of the Articles of Agreement. It is not a special facility that would provide resources under special terms. Rather, it is a policy designed to increase the predictability of resource availability under existing facilities. A similar mechanism was established to enhance the predictability of financing for Debt and Debt Service Reduction Operations in the context of the Fund's support of the Brady Plan. In that case, as is envisaged under the TIM, the financial terms were those of the underlying policy under which the access is granted (i.e., upper credit tranches, EFF, or PRGF).

The TIM is expected to create a modest increase in IMF financing, for two reasons. First, the explicit emphasis on trade adjustments will ensure that they are carefully estimated and incorporated into the Fund-supported program. Second, the deviation feature provides

countries with a greater degree of certainty that larger-than-anticipated adjustments can be accommodated.

A member country could request consideration under the TIM if it expects a net balance of payments shortfall as a result of measures implemented by other countries that result in more open and nondiscriminatory market access for goods and services. Such measures would normally be introduced either (i) under a WTO agreement or (ii) on a nondiscriminatory basis. The implications of own liberalization measures would not be covered by the TIM, although the Fund will, of course, continue to assist members in anticipating and managing the implications of domestic reforms that may be associated with Doha Round commitments, including by considering any necessary financing under the Fund's existing policies.

A Fund policy aimed at addressing financing needs arising from multilateral trade liberalization is justified on several grounds. First, several members will probably face these needs. Even if only a subset eventually requires financial assistance, the TIM would help ensure that a common framework of analysis and financial support is applied across the membership. Second, the events that are the subject of the policy are predictable and largely exogenous from the perspective of individual members. The policy would provide a focal point for dialogue with the authorities that would help encourage the early identification of financing needs and associated policy actions. Third, and most importantly, the TIM would represent a concrete expression of policy coherence, in the context of what is arguably the single most important item on the multilateral economic policy agenda over the coming period. In addressing specific concerns expressed by members during the trade negotiations, the policy is designed to help advance the Doha Development Agenda.

Finally, it is important to note that Fund assistance to ensure that countries can take full advantage of the opportunities of multilateral trade liberalization is not limited to financial support. Fund experts provide significant and long-standing assistance for customs reform, tax and tariff reform—including to mitigate the revenue implications of liberalization—and for data improvements. In the areas of its expertise, the Fund also contributes actively to the Integrated Framework process, which aims at strengthening consideration of trade reforms in national poverty reduction strategies and at coordinating trade-related technical assistance. In the process of Article IV surveillance, Fund staff engage with country authorities in identifying areas of opportunity and risk, and in devising appropriate policy responses to the challenges of international integration. The Fund has also strengthened its research capacity in the trade area, and is helping to develop methodologies for assessing the impact of Doha Round reforms on member countries.

I. INTRODUCTION

1. **Multilateral trade liberalization has been a major contributor to the world economy's unprecedented growth over the past half century. In tackling remaining restrictions on trade, the current WTO round has the potential to benefit all countries.** With its development focus, the Doha Round offers particular scope for promoting the deeper integration of developing countries into the global economy, and thus to broaden their sources of growth. A successful round would combine ambitious improvements in market access, for agricultural and industrial products as well as services, with a significant reduction in trade-distorting subsidies.

2. **While benefiting economies overall, opening the world trading environment further would require countries to adjust.** Concerns over the costs of adjustment, in particular among developing countries, are adding further complexity to the WTO negotiations. Adjustment can be promoted and its social impact mitigated by policies, investments, and institutional reforms aimed at stimulating a supply response and strengthening social safety nets. The Fund can help its members in this area by strengthening the focus on such issues in its policy dialogue with member countries in the context of Article IV consultations. Furthermore, both the Fund and the World Bank have a range of instruments available to assist countries in designing and implementing appropriate responses through the provision of technical and financial assistance as well as analytical support.

3. **Implementation of Doha Round agreements may also give rise to temporary balance of payments shortfalls.** Fears over external imbalances, as a result of terms of trade changes, the liberalization of imports or—especially—more intense competition in export markets due to preference erosion, have led a number of developing countries to question the wisdom of subscribing to an ambitious Doha Round. While the Fund has provided assurances of support within its existing policies and instruments, several members have called for a more tailored approach that addresses the balance of payments impact of trade adjustment and is sufficiently flexible to respond to unanticipated shortfalls.

4. **At an informal Executive Board meeting on September 3, 2003 Directors discussed the outline of a possible new policy framework, which would allow the Fund to tailor its support to all members to the particular demands of trade adjustment and, most immediately, under the Doha Round.** Subsequently, the First Deputy Managing Director announced the Fund's new proposed initiative at the WTO Ministerial Meeting in Cancún. At its meeting in Dubai, the International Monetary and Financial Committee endorsed the initiative, stressing its importance in helping countries address the transitional impact of trade reform.

5. Section II outlines the rationale for the proposed policy. Sections III and IV discuss the main elements of the new policy instrument. Section V evaluates the implications for Fund liquidity and staff resources and Section VI summarizes.

II. Balance of Payments Implications of a New Multilateral Trade Agreement

A. Scope of the Negotiations and Sources of Balance of Payments Shortfalls

6. **Negotiations under the WTO's Doha Round, which was launched in 2001, will involve deeper commitments under a broad range of issues**—including market access in goods and services, disciplines on trade-distorting supports and trade remedies, rules on a range of trade-related domestic policy measures, and special and differential treatment of developing countries and least developed countries (LDCs). Among others, the Doha Declaration envisages significant reforms in agriculture, which has, so far, experienced only modest de facto liberalization.[1]

7. **The successful conclusion of the Doha Round negotiations will offer both developing and industrial countries new opportunities to integrate further into the world trading system.** On balance, the net effect of the multilateral liberalization envisioned in the Doha Round should be significant and positive. Nevertheless, there may be adjustment costs and a temporary deterioration in the balance of payments for countries where the net impact of liberalization over the medium and longer term is favorable. The possibility of such imbalances is, in large part, associated with liberalization in exactly those areas where the Doha Round is meant to achieve meaningful progress for developing countries—in agriculture and labor-intensive manufactures, where levels of protection and trade-distorting supports remain especially significant.

8. **The negotiations have highlighted several implications of a Doha Round agreement that might result in temporary balance of payments shortfalls**: the erosion of the margin of tariff preferences under preferential trading arrangements (PTAs) as most-favored-nation (MFN) tariffs decline; adverse changes in the terms of trade of net food importers as agricultural subsidies are cut; and more intense competitive pressures in the markets for textiles and clothing following the elimination of bilateral quotas in 2005 under the WTO Agreement on Textiles and Clothing (ATC). While the latter was agreed during the Uruguay Round, it has nevertheless raised concerns during the current negotiations, where it has been linked to the possible erosion of preferences for the same products. The Trade Integration Mechanism (TIM) is intended to address these kinds of developments, which would be the result of the—collectively agreed—liberalizing action by a country's trading partners, rather than of policy measures taken by the country itself.

---

[1] See "Market Access for Developing Country Exports—Selected Issues," SM/02/280, Revision 1, September 26, 2002.

9. **While similar concerns were raised in past rounds of multilateral trade liberalization, the effects are potentially larger under a Doha Round agreement.**[2] The Doha Declaration sets ambitious goals for the liberalization of agricultural trade, where remaining tariff barriers remain especially high. Under the Uruguay Round, which was the first to cover agriculture comprehensively, tariff cuts were applied to rates some of which were initially raised as a result of the "tariffication" of quotas, and the particular formula that was used allowed many important products to escape significant liberalization.[3] Similarly for subsidies, where reductions in the Uruguay Round were applied to a base period in which subsidy levels far exceeded those at the time of the agreement and led to only limited reductions in practice. Furthermore, preference margins were traditionally in the form of fixed or percentage reductions from MFN rates.[4] With many preferential rates set at zero under recent schemes such as African Growth and Opportunity Act (AGOA), Everything-but-Arms, or the European Union association agreements, a cut in MFN rates translates directly into a loss of preference. Finally, as mentioned, the phasing out of textile quotas, while agreed previously, is for the most part becoming effective only in 2005. Textiles and agriculture together account for a large share of the value of preferential regimes for developing countries.

B. Impact of Own Liberalization

10. **Temporary payments imbalances may also be associated with the implementation of a country's own commitments under a multilateral agreement.** Thus, liberalization could conceivably lead to an import surge. A number of developing country delegations have also drawn attention to the expected loss of fiscal revenue from tariff reductions. In the absence of mitigating measures, it is possible that such revenue shortfalls would translate into balance of payments pressures. Trade liberalization in services, including financial services, could give rise to capital flows which—though potentially an important source of benefits of a Doha Round agreement—might also result in increased volatility of reserves if the macroeconomic or regulatory framework is weak.

---

[2] For the reason explained in this paragraph, the Uruguay Round does not offer an appropriate "testing ground" to evaluate the possible impact of the proposed Trade Integration Mechanism.

[3] The Uruguay Round formula set a simple average rate of tariff reduction of 36 percent, and a minimum for each tariff line of 15 percent. Since only a small share of total tariff lines cover many of the relevant tariffs, the targeted average reduction did not require more than the minimum cuts in many of the highest and most important tariffs.

[4] Important exceptions were the successive Lomé Agreements of the European Union, which allowed duty-free entry for a broad range of goods, although preferences were more limited for sensitive agricultural products.

11. **However, in these cases, the balance of payments impact, and indeed the occurrence of the negative event itself, cannot be considered separately from the macroeconomic framework and the authorities' policy response.** Overall import surges can be avoided by proper macroeconomic management. Macroeconomic stability, regulatory policies and appropriate sequencing can go a long way towards mitigating the volatility of capital flows. The erosion of tariff revenues depends on characteristics of the tariff and customs regimes and can often be contained by other fiscal measures, such as eliminating exemptions, improving the administration of tariffs and taxes, and strengthening domestic taxation. Nonetheless, in countries that are vulnerable on any of these dimensions—for example, where tariff revenues constitute a major share of total government revenues, or the prudential framework in banking is weak—any liberalization has to be carefully monitored to ensure that supporting policies are in place. Technical assistance, including by the Fund, can play an important role in this respect.[5]

12. **Own liberalization and the supporting policy framework have been a standard part of Fund-supported programs and are not specific to the multilateral negotiating context.** The Fund, of course, continues to stand ready to assist members in anticipating and managing the implications of domestic reforms that may be associated with Doha Round commitments, including by considering any necessary financing under the Fund's existing policies, where appropriate. Reforms to the domestic trade regime, including in services, are often an integral part of the design of the overall policy framework under Fund-supported programs and it would seem artificial, and might complicate program design and negotiations, if they were dealt with under a separate policy. It is therefore proposed that the implications of own liberalization measures should not be covered by the TIM, whose purpose is to provide a procedurally simple way of meeting some of the concerns expressed about broader reforms associated with the current global trade talks.

C. Estimating the Impact of Adverse Shocks to the Balance of Payments

13. **The specific impacts of the trade reforms are in many cases hard to measure and disentangle from other factors.** This is especially the case in the context of any reform where the supply response of third countries is both uncertain and central to the assessment of impact. Trade data also tend to become available with a lag of several months. Nevertheless, modeling techniques, the analysis of historical data series and certain economic characteristics can indicate orders of magnitude and help identify vulnerabilities. Work is underway both at the Fund and in a variety of other institutions (World Bank, UNCTAD, OECD, among others) to refine methodologies for impact assessments, especially of

[5] The Managing Director, in his address to the General Council of the WTO (May 13, 2003), expressed the readiness of the Fund to consider any requests for technical assistance in managing the implications of tariff revenue erosion as a result of trade liberalization.

preference erosion and the expiry of the ATC.[6] As such methodologies are developed in the course of 2004, they will assist Fund staff and country authorities to better quantify the impact of trade reforms. Detailed calculations will also require sound external trade data. This underlines the need for authorities to carefully evaluate the quality of trade statistics without delay, and to make needed improvements, including through participation in the General Data Dissemination System.

14. **Model simulations suggest that the impact of preference erosion is unlikely to be large for most countries. However, for a minority of countries the impact could be significant.** Box 1 reports on the distribution of preference erosion among beneficiary countries. In a fairly ambitious liberalization scenario, a reduction in export unit values of more than 2 percent would be limited to around two dozen countries. The associated loss of export income would tend to be larger to the extent that export volumes decline in response to the price competition. Nevertheless, using a simple partial equilibrium model, Subramanian (2003) estimates the aggregate loss of export income for LDCs from preference erosion to be less than two percent of total exports.[7]

15. **Similar results obtain with regard to the implications of reduced agricultural subsidies, or a decoupling of these subsidies from production decisions, for the terms of trade of net food importers.** [8] As mentioned, the effective reduction of subsidies under the Uruguay Round was fairly limited. The terms of trade loss for most countries is likely to have been well below 1 percent,[9] and price changes for individual products in the range of plus or minus 5 percent. Simulations of a full elimination of trade-distorting subsidies arrive at a price impact of up to 20 percent for major food staples,[10] but any Doha Round agreement is unlikely to be quite that ambitious. Several net food-importing developing countries

---

[6] The World Bank is sponsoring a project aimed at measuring the extent to which preferences are actually utilized in the United States and the EU. An initial seminar will be held in Geneva on March 31, 2004 to present methodologies and initial results.

[7] Arvind Subramanian, "Financing of Losses From Preference Erosion," in "WTO Notes and Cover Letter from Ms. Krueger," EB/CWTO/03/2, January 27, 2003; subsequently issued by the World Trade Organization as WT/TF/COH/14, February 14, 2003.

[8] Based on FAO and IMF data, a total of 17 Fund member developing countries had net food imports exceeding 20 percent of total exports in 2001.

[9] James E. Anderson, 1997, "The Uruguay Round and Welfare in Some Distorted Agricultural Economies," NBER Working Paper 5923 (Cambridge, MA: National Bureau of Economic Research).

[10] For example, Stephen Tokarick, 2003, "Measuring the Impact of Distortions in Agricultural Trade in Partial and General Equilibrium," IMF Working Paper 03/110.

Box 1. Estimates of Preference Erosion

The extent of preference erosion depends on the size of initial preference margins and the tariff reduction formulas agreed in the multilateral negotiations. Both are highly product-specific and preference margins differ across bilateral trade relationships. Moreover, effectively utilized preferences tend to be significantly lower than statutory preferences, either because exporters are unable to meet complex rules of origin and other procedures, or because margins are too small to warrant the often considerable administrative effort associated with them. UNCTAD has estimated that utilization rates of the GSP schemes of Canada, the EU, Japan and the United States average less than 40 percent from all sources.[1] Making the conservative assumption of a 100 percent rate of utilization of preferences, the table below reports the reduction in export unit values, by country, in a scenario where MFN liberalization results in a 40 percent cut in preferences and assuming homogeneous products and constant world market prices (only reductions greater than 2 percent are reported).[2] In reality, for many commodities world prices are likely to rise as MFN liberalization raises the level of global demand, thus dampening the impact on export unit values. The resulting change in export revenues will further depend on product-specific export supply elasticities. For illustration, an average export supply elasticity of 1 would result in a loss of export revenue of approximately twice the change in export unit values reported in the table.

Percentage Decrease in Average Export Unit Values Following a 40 Percent Cut in Preference Margins as a Result of Multilateral Tariff Reduction (Estimate)

Least Developed Countries		Other Developing Countries	
Malawi	6.6	Mauritius	11.5
Mauritania	4.8	St. Lucia	9.8
Cambodia	4.1	Belize	9.1
Bangladesh	3.9	St. Kitts and Nevis	8.9
Maldives	3.5	Guyana	7.9
Haiti	3.3	Fiji	7.8
Cape Verde	3.3	Dominica	5.5
São Tomé and Príncipe	2.7	Seychelles	4.2
Tanzania	2.4	St. Vincent and the Grenadines	3.4
Comoros	2.0	Jamaica	3.3
		Albania	3.3
		Nicaragua	3.2
		Swaziland	3.0
		Serbia and Montenegro	2.9
		Tunisia	2.2
		Côte d'Ivoire	2.2
		Morocco	2.1
		Dominican Republic	2.1

Sources: Export structure and direction: COMTRADE (United Nations). Preference regimes: WTO Trade Policy Reviews, TRAINS database.
Note: Only preference erosion vis-a-vis Canada, the EU, Japan, and the United States considered. Calculation of current preference margins uses tariff data per 2-digit tariff line for each preference scheme. Direction of trade data are then applied to obtain a trade-weighted preference margin.

---

[1] UNCTAD, 2003, "Trade Preferences for LDCs: An Early Assessment of Benefits and Possible Improvements," New York and Geneva, September (draft).

[2] This would be the case, for instance, for a 40 percent reduction in MFN rates (slightly more than the average under the Uruguay Round) in a market with zero-duty preferential access, as would be the case for many products exported under the EU's Everything-but-Arms Initiative and the United States' AGOA.

(NFIDCs) are net exporters of some nonfood agricultural products, and price effects may partly cancel out in their impact on the balance of payments. Finally, domestic production in some NFIDCs is likely to expand in response to higher prices, thus improving the domestic food balance.

16. **The impact of the phase-out of textile quotas is even harder to predict, but potentially large for a subset of countries.** In order to avoid abrupt adjustments, the ATC envisaged the liberalization of textiles and clothing trade in four phases over the period 1995–2004. However, in practice the liberalization of restrictive quotas has been backloaded, with an estimated 80 percent remaining to be eliminated by the end of the implementation period. Signs of shifting competitiveness have already begun to emerge and may provide an indication of developments following full liberalization in 2005. In 2002, when approximately 15 percent of restrictive quotas were eliminated (Phase III of the ATC), China increased its exports of the liberalized products to the United States and EU by more than US$2 billion, while many other suppliers experienced a contraction in value terms and import unit prices declined sharply (Table 1).

Table 1. Selected Countries' Exports of Textiles and Clothing to the United States and EU
(Products Liberalized in Phase III of the ATC, Percentage Changes Jan.-Sept. 2001 vs. Jan.-Sept. 2003)

Exports to the United States			Exports to the EU[1/]		
Origin	Change in Value (US$)	Change in Volume	Origin	Change in Value (€)	Change in Volume
World	16.7	64.4	World	5.1	27.5
China	193.6	652.6	China	90.8	377.1
Pakistan	13.2	27.7	Romania	19.9	27.2
India	12.2	1.8	Czech Republic	7.8	1.3
Turkey	-9.5	-9.2	Turkey	-3.0	-22.8
Egypt	-20.0	-20.0	Tunisia	-4.3	-18.0
Mexico	-20.5	-10.8	India	-12.5	-9.5
Indonesia	-35.7	-36.3	Morocco	-12.7	-19.0
Cambodia	-43.2	-31.1	Sri Lanka	-21.6	-0.6
Bangladesh	-43.6	-41.9	Bangladesh	-41.2	-8.4
Philippines	-57.9	-53.8	Thailand	-44.8	-26.9
Sri Lanka	-57.9	-64.5	Vietnam	-49.0	6.6
Thailand	-62.0	-64.7	Indonesia	-50.1	-30.7

Sources: United States International Trade Commission and the European Community, respectively.
1/ Includes only those categories liberalized in Phase III of the ATC where China had quotas.

17. **The balance of payments implications can be larger where countries are subject to several adverse developments at the same time.** Using a simple set of indicators of vulnerability to the trade policy events identified above, however, it would appear that only a relatively small number of countries might be subject to significant impacts from more than one source.[11]

D. Estimating the Net Impact of a Multilateral Trade Agreement

18. T**he adverse developments do not, of course, represent the full impact of a Doha Round settlement on a country's external trade position or its balance of payments.** A full analysis would need to take account of changes in the trade profile as imports and exports more generally adjust to the new trade policy environment. Available studies suggest that the net impact of a comprehensive agreement on export development, over time, is overwhelmingly positive for all country groups.[12] For example, simulations with the Global Trade Analysis Project model of international trade demonstrate that any negative impact tends to be more than offset by other factors (although estimates are very sensitive to parameter specifications). These include the benefits of better access to markets in countries that do not at present offer preferential access, and particularly the positive effect on competitiveness of countries' own liberalization efforts.[13]

19. **There may be immediate adjustment costs and a temporary deterioration in the balance of payments even when the long run net impact of liberalization is positive.** On the other hand, trade policy changes agreed in the WTO are generally phased in over many years. The economy therefore has longer to adjust. The negative impacts in any one year will tend to be more modest and gradually offset by the positive impacts from market opening by trading partners. One exception may be the impact of the ATC quota phase-out, which has

---

[11] The indicators are: (i) an estimated 2 percent or larger decline in export unit values associated with a 40 percent erosion of preferences; (ii) net food imports represent more than 20 percent of total exports; (iii) a composite measure of vulnerability based on the concentration of exports of textiles and clothing, quota utilization rates and capacity for adjustment. According to these, admittedly arbitrary, cut-off points, only one country would be vulnerable to all three of the adverse impacts (Cape Verde), while ten would be subject to two. In some cases, different trade events might have directly offsetting impacts on the balance of payments.

[12] This may not necessarily be true for every country individually, and considering trade policies in isolation. However, open trade is closely intertwined with other aspects of growth- and export-promoting reforms and resolving exact causalities is of more interest academically than in policy practice.

[13] See *Global Economic Prospects 2004: Realizing the Development Promise of the Doha Agenda* (World Bank: Washington, DC).

been backloaded with most of the impact coming at the end of the 10-year implementation period on January 1, 2005.

20. **It is difficult to arrive at point estimates of the balance of payments implications of trade liberalization in practice.** General equilibrium models with the required product detail and reliable parameter estimates are unavailable for many countries. Furthermore, a full assessment would also require examining the macroeconomic implications of multilateral liberalization. Second-round macroeconomic effects might operate both through the current account (where changes in real incomes or in income distribution may affect savings-investment balances) and the capital account (where capital inflows may be encouraged). The worldwide real income gain from multilateral liberalization would be expected to strengthen trade performance more generally. Finally, the balance of payments implications would also depend on the foreign exchange regime in place in the country in question.

E. The Nature of Balance of Payments Impacts and Implications for Fund Support

21. In considering the merits and structure of a Fund financial response to these types of trade adjustment issues, it is important to note that **the implications of a multilateral trade agreement differ from those of other shocks**, such as commodity price volatility:

- **First, the changes in relative prices and market access will be permanent**. Member countries will need to adjust to these permanent changes in the world trading environment and, during the period of adjustment, may face a temporary deterioration in their balance of payments. Nevertheless, the impact over time of the changes can be presumed to be positive, and any necessary adjustment would be largely structural, rather than macroeconomic in nature.

- **Second, the measures giving rise to these impacts are preannounced and can be anticipated, rather than being sudden and unpredictable.** The impact on the balance of payments could therefore be incorporated into the baseline of a Fund-supported program.

- **Third, the practical difficulties in determining the exact size of the impacts ex ante mean that, of course, outcomes may differ from projections.** This suggests that a clear-cut rule relating impacts to access (as under the Compensatory Financing Facility (CFF)) would not be workable in this case. It also implies the need to build flexibility into any policy.

22. **The speed of adjustment and duration of any negative balance of payments impact will depend on the export supply response and the ability of affected countries to diversify their export and domestic production base.** Many of the policy measures to promote adjustment are microeconomic in nature—labor market policies, training programs, infrastructure, and institutional reform. Additional policy measures may be required to ease the social impact on population groups heavily exposed to the affected sectors. These issues fall within the expertise of the World Bank and other institutions. Nevertheless, as has been

the experience in past episodes of trade liberalization, the Fund's role in supporting an appropriate macroeconomic and fiscal framework and measures to enhance the overall environment for business development will often be important and complementary to such policies.

III. Trade Integration Mechanism

A. Overview

23. **The proposed mechanism would detail how the Fund would provide access to its resources as necessary to meet a balance of payments need associated with the net effect of specified trade measures**.[14] Consistent with the principle of uniformity of treatment, the Trade Integration Mechanism would be available to all member countries whether or not they are also members of the WTO. More specifically, the Fund would:

- stand ready to discuss **new arrangements in the upper credit tranches, the EFF, or the PRGF,** with countries facing balance of payments shortfalls as a result of specified trade events;
- take into account the anticipated impact of these specified trade events in determining the **appropriate size of access** during discussions with the authorities on new Fund arrangements or within scheduled program reviews (the "baseline feature"); and
- be prepared to **augment arrangements** for countries that have already incorporated a trade adjustment baseline into the program but where the actual balance of payments effect is larger than anticipated (the "deviation feature").

24. **The TIM would not be a special facility that would provide resources under special terms. Rather, it is a policy designed to increase the predictability of resource availability under existing facilities.** A similar mechanism was established to enhance the predictability of financing for Debt and Debt-Service Reduction Operations in the context of the Fund's support of the Brady Plan.[15] In that case, as is envisaged under the TIM, no special financial terms were made available.

25. **A Fund policy aimed at addressing financing needs arising from multilateral trade liberalization is justified on several grounds.** First, several members will probably face these needs. Even if only a subset eventually requires financial assistance, a special policy would help ensure that a common framework of analysis and financial support is applied across the membership. Second, the events that are the subject of the policy are predictable and largely exogenous from the perspective of individual members. The policy

---

[14] The measures are set out in Section IV.

[15] "Fund Support for Debt Reduction Operations—Preliminary Considerations," EBS/89/78, April 19, 1989.

would provide a focal point for dialogue with the authorities that would help encourage the early identification of financing needs and associated policy actions. Third, the TIM would represent a concrete expression of policy coherence, in the context of what is arguably the single most important item on the multilateral economic policy agenda over the coming period.[16] In addressing specific concerns expressed by members during the trade negotiations, the policy is designed to help advance the Doha Development Agenda. While the Fund has signaled its support within the framework of existing policies, these have provided insufficient comfort, and members have continued to question the desirability of meaningful liberalization targets in light of the potential balance of payments implications. And fourth, countries may increase the size of their own commitments if they are assured of support, a result that would be expected to benefit their economic performance.

26. **At the informal meeting of the Executive Board on September 3, 2003, some Directors expressed concerns that the TIM might weaken the commitment to liberalize trade rather than strengthen it, and that it might lessen incentives to adjust.** However, qualification for the TIM depends on the specified trade events having occurred. Therefore, the TIM does not substitute for liberalization commitments but would, on the contrary, weaken one possible source of opposition to liberalization. Access under the TIM is linked to the implementation of an appropriate policy framework, thus ensuring that it is associated with any necessary adjustment.

27. **The TIM would be consistent with the Fund's evolving approach to low-income countries.** The approach underlying the TIM would be flexible; it would avoid a generalized increase in access to all low-income member countries, and it would channel Fund assistance to countries that face exogenous changes in their economic environment.

B. Alternative Approach

28. **An alternative approach would be to allow individual purchases outside the context of an arrangement, but that would raise a number of difficulties.** Most significantly, financial support of this nature still needs to be associated with an appropriate macroeconomic environment, which may entail adjustment. This issue has come up in the implementation of the CFF, which was amended in 2000 to provide for stand-alone purchases without an accompanying arrangement *only* in cases where the balance of payments situation was otherwise found to be satisfactory—a test which is not often met. Moreover, a key benefit of the TIM is the enhanced predictability of access, which is well served through an arrangement that constitutes an assurance of use of Fund resources under specified conditions. Another reason for rejecting this alternative approach is that individual disbursements outside the context of an arrangement are not contemplated for PRGF financing.

---

[16] The commitment to coherence in international policymaking has been repeatedly underlined by the governing bodies of the Fund, the Bank, and the WTO.

C. Other Aspects of Fund Assistance with Trade-Related Adjustment Needs

29. **Fund assistance to ensure that countries can take full advantage of the opportunities of multilateral trade liberalization is not limited to the proposed financial support.** Technical assistance and capacity building are crucial aspects of the Doha Development Agenda given the increasing complexity of the trade talks and policy, administrative, logistical and other constraints on trade that can limit the supply response. Fund experts provide significant and long-standing assistance for customs reform, tax and tariff reform—including to mitigate the revenue implications of liberalization[17]—and for data improvements. In the areas of its expertise, the Fund also contributes actively to the Integrated Framework process, which aims at strengthening consideration of trade reforms in national poverty reduction strategies and at coordinating trade-related technical assistance. In the process of Article IV surveillance, Fund staff engage with country authorities in identifying areas of opportunity and risk, and in devising appropriate policy responses to the challenges of international integration. The Fund has also strengthened its research capacity in the trade area, in a step that will enhance its ability to cooperate in developing methodologies for assessing the impact of Doha Round reforms on member countries.

IV. MODALITIES OF THE PROPOSED TRADE INTEGRATION MECHANISM

A. Qualification

30. **Member countries would qualify for Fund support under the Trade Integration Mechanism if they have a balance of payments need related to specified trade events and have adopted a policy framework that supports adjustment**. The TIM could be activated either with the approval of a new arrangement with upper credit tranche-type conditionality or in the context of completing a review under an existing arrangement.

31. **More specifically, qualification would be limited to those countries experiencing balance of payments difficulties arising from trade liberalization measures introduced by other countries that result in more open market access for goods and services or remove trade-distorting subsidies.** Qualifying liberalization measures would normally be limited to measures introduced either (i) under a WTO agreement or (ii) on a nondiscriminatory basis. While it is not the intention to formulate an exclusive list of qualifying events, these would typically cover measures that result in the following:

a. the erosion of preference margins in key export markets;
b. a shift in the food terms of trade to the detriment of net food importers; or

---

[17] Fund staff have prepared several studies of the revenue impact of trade liberalization, for example, Occasional Paper No. 180, "Revenue Implications of Trade Liberalization" by Ebrill and others (1999) and "Revenue Implications of Trade Liberalization" (SM/01/255, August 8, 2001). Further work is currently underway to address this issue and inform Fund surveillance and technical assistance.

c. intensified competition in markets for textiles and clothing due to the elimination of bilateral quotas.

As noted above the liberalization measures would normally qualify if they are taken within the framework of the WTO. They would also qualify if taken in another context (e.g., unilaterally or on a regional basis), provided that measures benefit all Fund members on a nondiscriminatory basis. For example, the erosion of preferences for certain developing country exporters, as a result of a reform of agricultural markets in one of the major trading nations, could give rise to qualification irrespective of whether these reforms were legally bound in the WTO.

32. **To help overcome balance of payments problems stemming from other negative trade-related events, member countries would continue to be eligible for Fund support under the Fund's other existing policies.** Also, members would not be precluded from seeking financial support outside the TIM for the type of balance of payments problems the TIM is designed to address.

B. Access

33. **Access under the TIM would be determined under the access policies applicable to the underlying facility from which access is provided (upper credit tranches, the EFF, or the PRGF).** Under the baseline feature, the anticipated impact of the specified trade events would be considered in determining the overall financing gap and the appropriate balance between adjustment and financing. The deviation feature envisages simplified procedures for augmenting access in the underlying arrangement under specified circumstances. While trade-related shocks would also be considered in determining access under the Fund's regular policies in the absence of the TIM, the existence of a dedicated policy would be expected to result in a modest upward shift in access under otherwise comparable circumstances. This is likely because of greater attention to trade-related vulnerabilities and a shift in the balance between adjustment and financing, particularly in the case of the deviation feature. Such a shift in balance would reflect the generally favorable impact of the trade reforms over time, and the benefits of contributing—by mitigating trade-related balance of payments concerns—to the broader liberalization of the world trading environment.

Table 2: Schematic of Access under Baseline and Deviation Feature

<table>
<tr><td>Existing arrangement predating TIM</td><td rowspan="2">TIM approved</td><td>Scheduled review: Request for consideration under the TIM. Possible modification of access under baseline feature based on projected impact</td><td rowspan="2">Trade adjustment impact on balance of payments</td><td>Augmentation of access under deviation feature considered if actual impact exceeds baseline projection</td></tr>
<tr><td>New arrangement following approval of TIM</td><td>Projected impact under baseline feature factored into access at approval of arrangement</td><td>Augmentation of access under deviation feature considered if actual impact exceeds baseline projection</td></tr>
</table>

Baseline feature

34. **The baseline feature of the TIM would address anticipated balance of payments needs over the course of the Fund-supported program.** Qualification for the baseline feature would be established as part of regular program design, either at the start of an arrangement or at the time of a scheduled program review. In the context of a request for the TIM, Fund staff would work with the authorities and other IFIs, as necessary, to identify the expected balance of payments impact over the program period associated with the trade events specified in paragraph 31 (“baseline impact”). As new information becomes available, the projection would be updated in subsequent program reviews.

35. **The baseline impact, defined as the direct expected impact[18] of the trade event prior to any adjustment, would form the basis of a policy discussion with the authorities.** The agreed adjustment effort would take account of the phasing of the impact and of any offsetting—though possibly delayed—implications of the more generally open trade environment for the balance of payments. The revised trade performance would be built into the medium-term balance of payments framework and factored into the access levels granted under the arrangement, either upon its approval or at the time of a program review (with the total amount of access normally remaining in line with general access policies).

36. **In the context of a program review, the Fund would consider a modification in access under the existing arrangement,** but only if a careful examination of expected changes in the trade environment established a revised net balance of payments shortfall and associated adjustment needs that exceeded earlier projections, and where the change was attributable to the anticipated impact of the specified trade events.[19]

Deviation feature

37. **The Board could decide to augment an arrangement supported under the TIM when the actual balance of payments effect (*ex post)* is larger than anticipated under the established baseline** (the difference is referred to as the "deviation"). This policy acknowledges that, while reforms agreed for instance in the Doha Round—once signed—are themselves predictable, their net impact may be subject to significant uncertainty. Augmentation would be done in light of *net* financing needs at the time, which are largely attributable to the specified trade reforms set out in paragraph 31.

38. **When approving the baseline feature, the Board would signal its willingness to consider an augmentation to cover the deviation, if and when the need arises.** The deviation would be defined with reference to the original baseline established when the TIM was approved, except in cases where access had been modified in the context of a program review. In the latter case, the baseline underlying the revised access decision would be the relevant reference in identifying a deviation. Given the uncertainties involved in disentangling different contemporaneous causes of a shortfall, it would be difficult to tie the size of the augmentation under the deviation feature to a precise estimate of the extent of the

[18] The direct impact is a "net impact" in the narrow sense that it refers to the impact on exports or imports minus directly associated changes in other items. For example, the impact of a reduction in garment exports would be net of reduced imports of fabric used in the production process.

[19] Such a modification in access, which would be based on the *projected* impact of the trade events, must be distinguished from possible augmentation *ex post* under the deviation feature of the TIM (based on the *actual* impact of the trade event).

deviation from the baseline. Instead, staff recommend that members would qualify under the TIM for an augmentation of a capped amount (see below) if:

a. there was evidence that the member was experiencing a larger than expected balance of payments need,
b. this was not due to a failure to implement agreed policies, and
c. in the Fund's judgment, the shortfall was related to the specified trade events whose impact exceeded earlier expectations.

Augmentation under the deviation feature of the TIM would thus require the underlying program to be on track with the exception of deviations, for example from NIR targets, which could be linked to the trade-related events. Accordingly, augmentation would not normally involve any additional conditionality.

39. **Augmentation under the deviation feature would be capped at 10 percent of quota per arrangement.**[20] Capping the standard augmentation at a relatively modest level would make it easier to accept streamlined procedures for approving the augmentation without unduly undermining the safeguards to the Fund. An augmentation review under the deviation feature could take place outside the scheduled program review cycle, in which case it would normally be expected to take place on a lapse-of-time basis upon the determination that: (i) the program is broadly on track and (ii) the additional financing is justified by the type of balance of payments need that the TIM was established to address.

40. **To the extent that a member faced a shortfall compared to the baseline that could not be accommodated by a 10 percent of quota augmentation, the entire program supported by the underlying arrangement would need to be re-evaluated.** In particular, it would be important to recalibrate the appropriate mix of adjustment and financing. A re-evaluation of the program of this kind in response to a much larger than anticipated shock could involve both higher access and new conditionality.

C. Conditionality

41. **Conditionality would be devised in the context of access under the underlying arrangement.** Conditionality associated with access under an arrangement incorporating the TIM in the baseline[21] will not differ in substance from that envisaged (in the hypothetical absence of the TIM) for the underlying arrangement inasmuch as the primary aims would be to ensure an orderly macroeconomic framework and an economic environment supportive of

[20] The 10 percent is not a target and, in cases where the Fund approves short arrangements for the member in quick succession, the previous activation of the deviation feature for a particular trade event may be taken into account in determining access.

[21] As mentioned, there is no expectation that access under the *deviation feature* would be associated with additional conditionality.

adjustment. Nevertheless, despite the expected temporary nature of any adverse macroeconomic impact of liberalization, there may of course be cases where the trade events that the TIM is designed to address are sufficiently large and their expected impact sufficiently durable that they would have a significant influence on the appropriate macroeconomic policy mix. These changes, and associated conditionality as necessary, would be incorporated in the underlying arrangement at the time of initial approval or in the context of a scheduled program review.

42. **Appropriate adjustment will require that sound macroeconomic policies are in place. Furthermore, adjustment calls for an overall policy framework that allows consumers to respond to changing world prices and investment, production to adapt to changing comparative advantage, and social policies that provide adequate safety nets for the poor.** These requirements are in line with those for any Fund-supported program and do not exclude the possibility that trade-related conditions would be included in the underlying program where appropriate. It would, however, be inappropriate for a member country receiving support under the TIM to introduce, or have in place, policies which prevented adjustment to the new trade environment.

D. Terms and Phasing

43. **The financing terms under the TIM would be those of the underlying policy under which original access was granted (i.e., upper credit tranches, the EFF, or the PRGF).** Both low- and middle-income members may wish to use the new TIM and financing terms will need to reflect their different circumstances. Unlike in the cases of other special policies and facilities such as the Supplemental Reserve Facility or the Y2K facility where the envisaged shock was expected to be short-lived, the trade events covered by the TIM may require structural adjustment that is no different in its duration from other adjustment processes under Fund-supported programs, suggesting that the repayment terms of the underlying facility would be appropriate. The phasing of disbursements under an arrangement incorporating the TIM would be set to reflect the overall profile of financing needs, including those related to the events that gave rise to qualification under the TIM.

E. Review Provision

44. **As the TIM is designed to ease adjustment to specified trade-events, which will be implemented over a limited time horizon, the policy is envisaged to be temporary.**[22] An appropriate date for the policy to lapse will depend largely (though not exclusively) on the phasing of measures agreed during the Doha Round. Staff proposes that an Executive

---

[22] While the impact of unilateral liberalization on third countries is covered by the definition in paragraph 31, the main purpose of the TIM is to address concerns that have arisen in the current Doha Round of the WTO.

Board review of the early experience with the policy be completed after three years, and a decision be taken at that time on the duration of the policy.

F. Relationship with World Bank Lending Operations

45. **Concurrent with the announcement of the Fund's initiative at the Cancún Ministerial Meeting of the WTO, the World Bank announced a parallel initiative aimed at addressing trade-related sectoral and institutional concerns (Box 2).** The World Bank's initiative could make resources available, for instance, for competitiveness-enhancing policy initiatives, labor market mobility, public investments, trade facilitation and logistics and reforms of trade-related institutions. Countries that were to avail themselves of the TIM may also request assistance from the World Bank under its lending instruments. In so far as members were to request concurrent support from both the Fund and the Bank under these new policies, the expectation would be that the two staffs would coordinate closely—in line with the established framework for Fund/Bank collaboration—to ensure that policy advice was tailored to addressing underlying problems while at the same time taking care to avoid any cross-conditionality between the Fund's and the Bank's policy instruments.

Box 2: World Bank Program in Support of Trade

During the WTO Ministerial Meeting in Cancún, the World Bank announced that it will step up its analytical and lending activities to assist countries take advantage of trade integration. The Bank's program has two components: (a) new resources devoted to *trade facilitation and logistics*, including investment in ports, roads, customs, and reform of trade-related institutions; and (b) support for governments designing trade reform programs to increase international competitiveness, take advantage of new trading opportunities, and mitigate any adjustment costs associated with reform programs. The second component will provide budget resources to help workers move into internationally competitive activities and provide resources for income maintenance, retraining, etc.

The Bank is already active in supporting trade facilitation and logistics development. There are a total of 73 trade-related lending operations under preparation covering 42 different countries. Roughly half of these operations focus on trade facilitation, central to long-term competitiveness.

Through the Trade Facilitation Initiative the Bank has developed new tools to help improve the quality of operations and disseminate best practice across the different regions. The Bank has increased staffing in critical areas such as customs, port management, and shipping security.

To leverage impact, the Bank is collaborating with other agencies and the private sector in creating a world-wide constituency for the implementation of trade logistics and trade facilitation reforms through a Global Trade Facilitation Partnership for Transportation and Trade**.** This group is serving as a forum for over one hundred international partners to collaborate and share information, including distance learning activities, on global best practices and capacity building.

V. Impact on Fund Liquidity and Resource Implications

A. General Resources Account (GRA)

46. **Purchases under the TIM are expected to remain within a manageable range and are unlikely to strain the Fund's liquidity position.** With or without the TIM, the Fund may be called upon to fill (in part) members' balance of payments gaps. Nevertheless, as noted earlier, the TIM may cause an upward shift in access.

47. **Applying the criteria set out in footnote 11 above, 17 non-PRGF eligible members would be potentially vulnerable to at least one negative trade event giving rise to qualification under the TIM** (considering preference erosion, food terms of trade changes, and the elimination of bilateral textiles quotas). Five of these countries currently have programs supported by Fund arrangements. It is difficult to estimate the *incremental* access attributable to the TIM. While the impact of the trade events can be large in individual cases, it would be reflected in balance of payments projections and at least partly considered for Fund financing under arrangements, even in the absence of the TIM. In a scenario in which additional access of 15 percent of quota on average can be attributed to the TIM, the total claim on liquidity over the full period of the trade adjustment process would be in the range of SDR 300–825 million depending on whether only these five or all vulnerable countries would avail themselves of the TIM in the context of one arrangement. Note that there is a possibility that requests would cumulate around the expiry date of the textiles quotas in early 2005—seven non-PRGF eligible countries are considered vulnerable to increased competitive pressures in textiles markets.[23]

B. PRGF Trust

48. **The TIM could have a more significant effect on available PRGF Trust resources that would need to be monitored closely.** As in the case of the GRA, the TIM could lead to an upward shift in access, especially in view of the relatively low access levels in successor arrangements.

49. **Staff estimates that, of the 76 PRGF-eligible countries,[24] 31 are vulnerable to at least one of the trade events specified in paragraph 31.**[25] Eighteen of these currently have PRGF arrangements. Again, under a scenario in which average incremental access of

---

[23] A decline of five percent in the textiles and clothing exports of these countries would amount to a revenue loss of close to US$1 billion (based on exports in 2000).

[24] Excluding India, which has indicated that it does not envisage to draw on PRGF resources, and Zimbabwe, which has been declared ineligible to draw on PRGF resources in light of its overdue obligations to the Fund.

[25] Criteria of vulnerability as in footnote 11.

15 percent of quota can be attributed to the TIM—under the baseline and/or the deviation feature—additional demand for PRGF resources during the full period of the trade adjustment process would be in the range of SDR 500–600 million (with each country drawing on the TIM in the context of one arrangement). The low end of the range reflects only those countries with current PRGF arrangements receiving additional access, while the high end is the outcome if all countries potentially subject to such shocks were to receive additional access. As additional demand for PRGF resources would span a period of several years, in line with the expected implementation schedule of trade liberalization commitments, it is currently projected that the additional demand can be met from available resources for PRGF operations. However, a bunching of requests around the date of the elimination of textiles quotas in 2005 could put some strain on meeting demand—eight PRGF-eligible countries are considered potentially vulnerable to the increased competition.[26] Available resources will, therefore, need to be reviewed regularly.

C. Staff Resource Implications

50. **The implications for staff resources of the TIM are difficult to establish at present but are not expected to be large.** Sunk costs have been incurred in preparing this initiative and the proposed three-year review of the policy would add to work pressures both among the staff and at the Board. The work pressures of country missions would increase to the extent that staff, including in response to requests from authorities, would need to develop more detailed data and analysis regarding the impact of multilateral trade liberalization than might otherwise have been the case. The resource implications will depend in part on the ability of staff to develop appropriate filters that allow a selective emphasis on the most relevant countries while avoiding excessive resource allocation to less relevant cases. The support of the functional departments, including PDR and RES, will be important in this respect. For arrangements involving the TIM, staff reports and LOI/MEFPs would of course be expected to include a stronger focus on trade-policy issues and on the justification for any request, although the incremental time and effort is unlikely to be large. The phasing of resource needs under the TIM is also dependent on progress in bringing the Doha Round to a successful conclusion; nevertheless, some of the concerns that the TIM is designed to address, in particular those relating to the phasing out of textiles quotas, are independent of the Doha Round timetable.

51. **Staff proposes to return to the Board with a firm costing as work progresses on developing methodologies of impact assessment and demand for the TIM becomes clearer.**

---

[26] A five percent decline in the exports of textiles and clothing of these countries would represent US$750 million in lost export revenue (based on exports in 2000).

VI. Concluding Remarks

52. **The impetus for proposing the TIM stems from concerns that developing countries have raised in the context of the Doha Round.** Many developing countries have been hesitant in their support for ambitious liberalization targets under the Round, arguing that such liberalization may reduce their competitiveness in export markets, cause unfavorable changes in their terms of trade, and weaken their balance of payments. An initial analysis suggests that there are unlikely to be grounds for serious concerns in a majority of countries, but that multilateral liberalization may place temporary adjustment pressures on a minority. While there is little doubt that the eventual impact of a Doha Round agreement would be overwhelmingly positive, the timing of impacts and the economic response, over which there is some uncertainty, may give rise to transitory balance of payments shortfalls.

53. **The proposed TIM is intended to provide added assurances to Fund members that short-run financial imbalances need not stand in the way of ambitious liberalization targets under the Doha Development Agenda.**