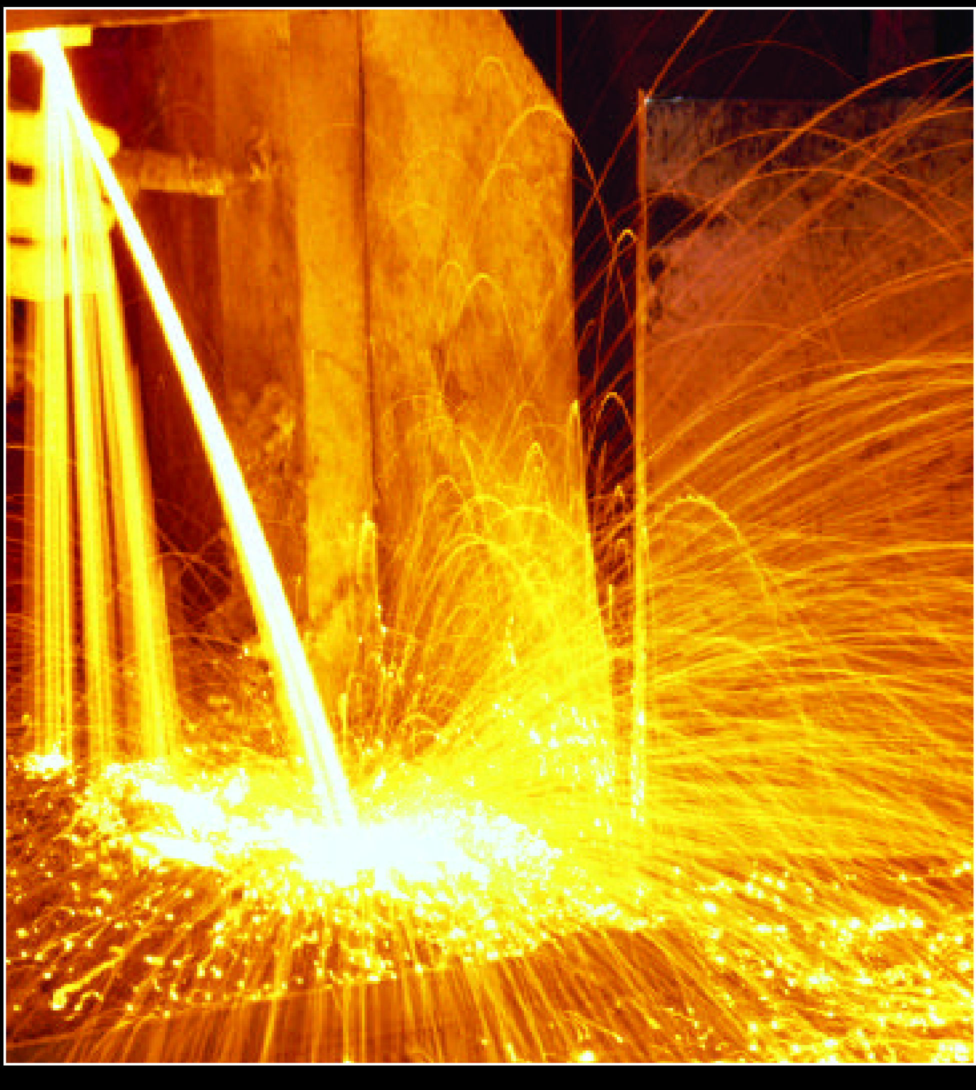
Cover Story

Navigation tips for a trade storm

With two-fifths of global trade falling under preferential trade agreements and numerous trade disputes hampering export flows in various parts of the world, plotting a secure route through the storms is not easy. Post the failure of WTO negotiations in Cancun, David Clarke examines the scene and assesses which path global trade is moving along and what impact this is having on financing.



Maybe by the 2008 Beijing Olympic Games the Doha round of World Trade Organization (WTO) talks will be completed.

Perhaps China and the Association of South-East Asian Nations will by then have firmed up plans to add to the more than 180 regional and bilateral free trade agreements signed so far. And this is not to mention the Free Trade Area of the Americas or the other 58 prospective free trade agreements (FTAs) under discussion or negotiation as notified to the WTO as of 17 March 2003.

Possibly US Airways will come out of bankruptcy and actually buy as many as 550 regional jets from Canada-based Bombardier Aerospace and Brazil-based Embraer, the subject of one of the countless trade disputes that roil international trade finance markets. With the rise in the number of trade disputes (25 new cases in 2003 to date), dispute settlement has become a big business for the WTO.

No one really knows what will happen in the brave new world of trade policy created by September's collapse of the WTO negotiations in Cancun, Mexico. Senior trade officials will meet in mid-December this year with an eye to taking the 'necessary action' needed to give ministers something to talk about at the next WTO ministerial meeting in 2005, in Hong Kong.

But WTO director general, Supachai Panitchpakdi, has made it clear that only the Cancun negotiating text will be on the table for the moment, over the objections of critics from the 21 nations that opposed continuing negotiations on that basis. Mexican foreign minister, Luis Ernesto Derbez Jaitley, says that: "The Cancun draft can't be the starting point of any discussion... It completely failed to gauge the mood at Cancun and was contrary to the mood prevalent there."

A leaked post mortem examination prepared by the UK's department of trade and industry into the failure at Cancun concludes: "We need to recognize privately that we may not get agreement on a basic framework by mid-December, and that much of our work may in practice be providing the groundwork for later rejuvenation of the round."

That sets the stage for more trade diverting bilateral and regional agreements, and ultimately more trade disputes. For as the report suggests: "A relative shift of power to (WTO) member states might give those with illiberal instincts greater scope to indulge them."

That is bad news for the otherwise promising prospects for global trade and economy. "Next year will be the first synchronized growth year for the world economy since 1996, with growth of 3.9%," says Stephen Poloz, vice president and chief economist at Export Development Canada (EDC) in Ottawa. "This is welcome news, especially considering that the world has not seen anything like normal economic conditions since that time. But the road forward will remain a bumpy one – normality is being redefined along the way, and its new defining characteristic is volatility."

Terrorist attacks of course are one destabilizing factor. Trade wars are another.

About two-fifths of world merchandize trade now falls under some kind of preferential trading agreement. The EU already has over 30 preferential trading agreements. The US seems intent on catching up, with 14 under negotiation on top of the six it has in place.

Dan Ciuriak at Canada's department of foreign affairs and international trade in Ottawa

In the post-Cancun climate, it is not hard to imagine 'an every bloc for itself' mentality taking over.

Opening markets one way or the other

Some remain sanguine about WTO prospects. China's president Hu Jintao says that: "Though the Doha round of WTO talks suffered some setbacks, so long as parties persist in consultation on an equal footing while shelving differences, it will be successful in the end."

While Poloz at EDC declares: "I suspect that Cancun will prove to be a detour, not a dead end, in a process that will take a very long time. As global conditions improve over the next twelve months, and we get the US election out of the way, the environment will become much more conductive."

But the Bush administration is hardly likely to hold its fire in the meantime.

US treasury secretary, John Snow, has warned the world not to depend on American consumers for growth. "While export growth can serve a useful purpose, you can't have a successful world economy if everybody relies on the export sector," he states. "Then you build in imbalances."

And US trade representative, Robert Zoellick, post-Cancun indicated that the US would more aggressively pursue bilateral and regional free trade agreements. "We are going to keep trying to open markets one way or the other," he stresses.

The US broadsides may miss their targets from time to time. And that may include some arm-twisting such as the US push for a revaluation of China's currency, the renminbi.

The US imported $141.8 billion worth of goods from China in the year to August, almost twice as➤

In search of the elusive NGO

It is easy for advocates of trade liberalization to demonize non-government organizations (NGOs), since they often sensationalize issues. But an articulate overview of export credit agency (ECA) issues is provided by Fraser Reilly King, coordinator, NGO working group of the EDC (Export Development Canada), which is a working group of the Halifax Initiative Coalition.

***Trade Finance* (TF):** The WTO, IMF and World Bank have been the target of major demonstrations by NGOs, but not ECAs. Why?

Fraser Reilly King (FRK): Even for ECA campaigners, many issues are not really being taken up because they are so technical. We need to talk about the much more problematic nature of all ECA operations and the WTO itself. There are the deeper issues of the environmental and social degradation of liberal trade regimes, reflected in supply side approaches of rich country ECAs seeking to expand markets for northern products, while acting protectionist with the South (developing countries), and maintaining public subsidies for their own industries.

TF: What are the prospects of linking development finance in the future?

FRK: ECAs provide trade rather than development finance. Consequently ECAs have a mandate to promote trade, rather than development. That said, project (and trade) finance can no longer be done without core standards.

To this extent, the recently adopted Equator Principles by commercial banks is a small nod to this.

The Equator Principles are a banking industry framework for addressing environmental and social risks in project financing. (London-based Dealogic ProjectWare has calculated that the 16 banks which have adopted the Equator Principles, arranged this year to date through August, have accounted for 88% of the project loan market.)

But still, development finance (through development finance institutions such as the World Bank and other multilaterals) would also be a lot less necessary if the North (industralized countries) would move on core issues that are buried in Cancun.

much as five years earlier before the PRC joined the WTO. China's WTO accession deal involved commitments to open its domestic markets and to meet its obligations for convertibility of current payments ➤ under the articles of agreement of the IMF — but it didn't insist on particular currency values or liberalization of China's capital account, let alone financial institution reform.

Is the US push for renminbi revaluation going to be effective? Especially in light of the trade dispute without a name, the US dollar revaluation?

"China's domestic financial system is not yet ready to cope with a free market currency regime," says Christopher Findlay, a senior official of the Pacific Economic Cooperation Council (Pecc). "We think that instead of the US putting pressure on the renminbi exchange rate it would be better to focus on speeding up China's trade liberalization process under the WTO."

At Canada's department of foreign affairs and international trade in Ottawa, Dan Ciuriak, senior economic advisor, trade and economic policy and trade litigation, believes: "The best way for China to help reduce global imbalances while supporting growth is to expand its imports. And it's moving in the right direction: China's imports are reportedly up 40.5% in the first nine months of 2003, compared to export growth of 32.3%. Part of the story of Japan's recent growth revival for example is a boom in exports to China."

And Ciuriak further explains: "The attention paid to China's nominal exchange rate peg is curious. The IMF's index for China's real effective exchange rate bottomed out at 79.9 in the second quarter of 1993 and then rose steadily to reach 125.9 in the first quarter of 2002, which also marked the US dollar's global peak. The full trough-to-peak real appreciation was 57.6%. During this period, China went from double-digit inflation to deflation; this evidence contradicts a theory of major under-valuation. In this light, China's external surpluses are better understood as largely reflecting its own growth slowdown at the time of the Asian crisis, coupled with sustained high domestic savings."

Even analysts who agree that the renminbi is significantly undervalued acknowledge that an exchange rate revaluation would do little to resolve the US external deficit. The argument goes that since more than half of China's exports are from foreign multinational companies, boosting the renminbi will have little effect beyond squeezing their profit margins.

The deal typically gets done

Despite trade frictions business is set to grow. "Our customers remain upbeat about growing opportunities in China after it joined the WTO," says David Weber, president of Wells Fargo HSBC Trade Bank, in San Francisco.

The same goes for Canada, says Weber, although its trade relations with the US are rocky. Softwood lumber is only one of a number of disputes with its partner in the North American Free Trade Agreement (Nafta).

Canada and the US enjoy the world's largest bilateral trading relationship. And Canada-US trade has grown considerably since the Canada-US Free Trade Agreement came into force in 1989. Between 1989 and 2002, Canadian exports to the US grew at an average annual rate of 9.3% while imports grew at 7.5%. Canada's trade surplus with the US also increased tremendously, from $4.4 billion in 1989 to a peak of $90.7 billion in 2001 before falling off somewhat to $86.4 billion in 2002.

But, does the lack of a level playing field with bigger US competitors create problems in the race for the share of the integrated continental market created by Nafta? "Not really," says Duarte Miranda, vice president, trade, RBC Global Services in Toronto.

Canada's banks have for years lobbied unsuccessfully with the federal government against a blanket ban on bank mergers, arguing that they need greater scale to

Duarte Miranda at RBC in Toronto

compete effectively with US giants.

Stresses Miranda: "Nafta has worked out well for Canada, which has enormous productive capacity that far outstrips the domestic market. True, the US market is and will remain key. But a surge in outwards investment spurred by the high Canadian dollar will eventually open new scenarios in other parts of the world as well. RBC is an institution with strong positioning, and the main consideration in taking on new opportunities is our risk assessment and appetite."

That includes forging new alliances in the US and elsewhere.

"The Wells Fargo HSBC model is a good one and one that we're familiar with," adds Miranda. "In fact, RBC has a number of effective working relationships in place with several institutions, including a partnership with HSBC and other institutions through Canada's Northstar Trade Finance."

Such adaptability is key to handling trade in stormy weather.

"Trade disputes and the ramifications of slow progress at the WTO are not an export financier's primary focus," says Terina Golfinos, managing director, head of structured export finance, Americas at ING Bank in New York. "We tend to deal with those transactions that have come to life despite any such disputes or governmental wrangling."

Emphasizing the value of structuring, Golfinos explains: "I am sure there are any number of transactions that don't quite make it to the financing stage due to one governmental prohibition or another. However, in this era of 'reasonably free trade,' creative financing solutions including alternative sourcing, asset based financing and so forth can be found to accommodate the most worthy of cross border trade flows. In other words, if an export or foreign direct investment project is deemed to be significant enough in terms of the competitive marketing advantages that result from its execution, then the deal typically gets done."

Lost lustre

So what ultimately are the prospects for trade tranquillity? Much depends on that old bugbear agriculture.

Selling trade liberalization has never been easy. But since the WTO was created in 1993 to replace the General Agreement on Tariffs and Trade (Gatt), the challenge has taken a quantum leap. To some extent, this was unavoidable. Through eight Gatt rounds, the easy areas for liberalization had already been mined; the remaining Doha round areas (agriculture, services, the hard wiring of differing socio-economic structures) pose much tougher problems.

And circumstances have conspired to raise the bar still higher for liberalization advocates.

Globalization lost much of its lustre, even with its strongest champions, due to the wave of emerging market crises in the second half of the 1990s. The difficulty of identifying benefits to the developing countries has compounded this by highlighting the uneven distribution of gains.

Multinational corporations which are in good measure the agents that deliver the gains from trade have largely lost interest in trade negotiations; and those that do have a keen interest (e.g., pharmaceuticals, biotechnology firms) are generally enmeshed in ethical/social/scientific controversies.

Curiously, while services issues – particularly intellectual property and immigration – are key for the WTO's future, the environment needed to address them and ease the inevitable shift of manufacturing to developing countries is being stymied by agricultural protectionism. ■ ➤

The gist of the matter

The OECD Arrangement on Guidelines for Officially Supported Export Credits are exempted from the Subsidies and Countervailing Measures Agreement at the WTO. Export credit agencies (ECAs) from emerging economies, specifically Brazil, are arguing that this is a subsidy that discriminates against their ECAs as it is impossible for developing countries to lend/insure at the floor set by the Arrangement.

The OECD Arrangement was initially negotiated in 1978 and revised most recently in 1998. The arrangement is not an OECD act, nor is it binding; rather, it is a 'gentleman's agreement' among the 24 governments who agree to be participants. Canada brought a claim to the WTO (because Brazil is not a participant to the Arrangement) and Brazil counter claimed.

The OECD is conducting a first phase of 'fast track' negotiations in which the participants apparently want to fix or clarify several financial issues that emerged from the Brazil/Canada dispute, to be concluded by 2004. They have also agreed to discuss other issues and have taken the opportunity to ask all participants whether there were other pressing issues to be negotiated. The exclusion of agricultural export credits is a controversial issue and one that has been on the negotiating table at the OECD since 1994.

According to the Australian department of foreign affairs and trade: "It is difficult to believe that an agreement amongst less than 30 nations (OECD arrangement) can exist without reference to an agreement signed by 138 members (WTO), particularly when a number of large exporting nations, such as China and Brazil, remain outside the OECD club."

"That is mixing apples and oranges," says Terina Golfinos, managing director, head of structured export finance, Americas at ING Bank in New York. "The vast majority of developing market exports require only rudimentary financing support. The issues facing participants are of a different order of complexity. OECD ECAs are mitigators of credit risk. Non-OECD ECAs are typically just providing promotional funding for their exports."

Still, there is a decidedly ungentlemanly populist appeal to Brazil's case which adds yet another wrinkle to the complexities of the task of liberalizing trade in the wake of the Cancun collapse.

Tallying the damages

The threat of retaliation to enforce World Trade Organization (WTO) decisions can be damaging to trade, especially when retaliation in the billions of dollars is authorized. Yet how real is the threat?

As we go to press, the WTO has ruled (on 10 November) that the action taken 18 months ago by the US imposing 30% tariffs on steel imports is completely illegal, and has thrown out the appeal lodged by the US and has firmly declared that the Bush administration has breached international trade rules. The ruling now allows the European Union (EU) to claim up to $2.4 million through retaliatory measures by introducing 100% duties on some US imports, effectively pricing the goods out of the EU

Steel: the WTO has ruled the US stance illegal

market. EU officials say they plan to target tariffs at goods produced in crucial states in the 2004 presidential election. The EU is being backed by Japan, China and South Korea. The US has until 6 December to remove the illegal tariffs.

Ironically, the tariffs were introduced by the Bush administration as 'safeguard' for the US steel industry. However, motor industry analysts reckon this measure has cost the US auto industry over $600 million through the last 18 months, while the US steel industry has only gained $60 million. The United Steelworkers of America and the Steel Manufacturers Association said in a statement that the ruling is an example, "of the broken WTO dispute settlement system," noting that the WTO has "never ruled in favour of a safeguard" on any product".

The UK alone is understood to have lost hundreds of millions of pounds worth of revenue because of the US action. But UK trade minister, Mike O'Brien, says: "We welcome the statement by president Bush that he will review the illegal tariffs. We hope we don't have to impose retaliatory measures." WTO director-general Supachai Panitchpakdi says he hopes the countries will be able to solve the problem without resorting to sanctions.

Dan Ciuriak, the economist on Canada's litigation team that went before WTO panels that set the quantum of retaliation in the Canada-Brazil disputes over regional aircraft subsidies, makes the following observations on the impact of disputes on the trading system.

"The power of the WTO, in popular conception, is based on the fact that its decisions in trade disputes can be enforced. In this regard, the WTO is held to be a big improvement over the General Agreement on Tariffs and Trade (Gatt)," states Ciuriak, senior economic advisor, trade and economic policy and trade litigation, within Canada's department of foreign affairs and international trade. "The big problem in effective enforcement under the Gatt was that the offending party could block a panel being formed (although few defendants actually did so).

"The WTO agreement gave certainty to the ability to apply retaliation if a complainant obtained a favourable verdict and the defendant did not comply. But in fact retaliation has been sparingly used, even when authorized. The issue seems to have become 'willingness to retaliate' because this involves domestic costs to the complainant, especially when the compensation authorized is large.

"Generally speaking, countries can be expected to be more willing to retaliate if domestic consumers have alternative sources of supply; by the same token, in such instances the defendant will likely be able to switch export markets meaning that the retaliation is not very costly to it either. In other words, this action is most likely to be used in cases where its deterrent value is, economically speaking, least.

"The result is that the value of retaliation as a deterrent is being brought increasingly into question by trade analysts except insofar as large industrial countries (such as the EU and US) can easily retaliate against small countries with limited export products, meaning that retaliation is also effectively inequitable!

"All of the above notwithstanding, the objective of the Gatt/WTO process is to get members to comply with their commitments and there is the presumption of good faith that members will comply, because they want to be seen as members in good standing. Seen in this light, the system works remarkably well."

In another longstanding dispute – over three years ago, the WTO authorized the EU to pursue as much as $4 billion a year in retaliatory trade sanctions over the US Foreign Sales Corporation, if the US did not change certain tax laws. Now EU trade commissioner, Pascal Lamy, says retaliatory sanctions against the US are a certainty if US congress fails to comply by the end of the year. That means the US needs to change the tax code to make American tax law comply with global trade rules The tax committees in the both the US senate and the house of representatives have each passed legislation aimed at bringing the US into compliance, but neither body has approved the measure.