MAINSTREAMING AID FOR TRADE FOR STRUCTURAL REFORMS IN THE CHANGING LANDSCAPE OF THE GLOBAL ECONOMY

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Mainstreaming Aid for Trade for Structural Reforms in the Changing Landscape of the Global Economy

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<td>ADB</td>
<td>Asian Development Bank</td>
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<tr>
<td>DDA</td>
<td>Doha Development Agenda</td>
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<td>IFI</td>
<td>international financial institution</td>
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<td>IMF</td>
<td>International Monetary Fund</td>
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<td>PBL</td>
<td>policy-based lending</td>
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EXECUTIVE SUMMARY

Today, external financial support to developing countries for trade policy reforms accounts for only a small share of overall aid for trade. Trade policy reform was strongly featured in balance-of-payments support and budget support of international financial institutions (IFIs) in the 1980s and the 1990s, but the use of trade-related conditionalities substantially declined in the later decades, mainly for two reasons. First, steady reduction of tariff rates was seen as demonstration of advancement of trade liberalization back then. Second, establishment of the World Trade Organization (WTO) in 1995 and launch of its Doha Development Agenda (DDA) in 2001 were expected to take over most of the outstanding issues for trade and development. However, these premises soon proved to be premature. After the global financial crisis in 2008–2009, the world economy entered the phase of slowbalization; and the use of trade-distorting measures in reverse of earlier trade liberalization spread across the globe. At the same time, the WTO’s Doha Development Agenda got deadlocked in 2008.

The current global trade landscape requires all multilateral institutions to join forces with the WTO to restore the open trade regime. IFIs can revitalize use of trade-related conditionalities in their policy-based lending to increase gains from trade for developing countries. Like the WTO’s multilateral trade negotiations and agreements, IFIs’ balance-of-payments and budget support, along with well-designed conditionalities, could catalyze country ownership of reforms by empowering reformers in domestic policy-making and advance trade liberalization. Such potential should be thoroughly examined to ensure that all countries enjoy the benefits of open and less discriminatory trade.
I. BACKGROUND

Notwithstanding the rising profile of aid for trade globally, only a small fraction of it has been allocated for trade-related structural reforms. According to data available for the period of 2002–2020, the share of disbursements and commitments allocated to trade policy and regulations and trade-related adjustments in the overall aid for trade has been less than about 3% of the total, lagging far behind those for building productive capacity and economic infrastructure development (WTO and OECD, 2022). On the multilateral front of general budget support and balance-of-payments support, the use of trade-related conditionalities in the policy-based lending (PBL) by international financial institutions (IFIs) appeared to have peaked once before the launch of the Doha Development Agenda (DDA) at the World Trade Organization (WTO) in 2001. However, the subsequent deadlock of the DDA, a phenomenon of so-called “slowbalisation” as coined by The Economist magazine,¹ and the rise of trade-distorting industrial policy amid geoeconomic fragmentation of the world economy (IMF, 2023) in the recent decades warrant a stronger call for aid for trade to supplement trade agreements to reverse such unfavorable trends.

Focusing on IFIs’ PBL, this paper examines the potential roles of aid for trade for advancing trade liberalization in developing countries.² The second section describes the historical use of trade-related conditionalities in IFIs’ balance-of-payments support and budget support, where data is available. The subsequent third section presents the context of today’s trade landscape and the case for reactivating use of trade-related conditionalities aimed at trade liberalization, whereas the fourth section briefly touches upon use of PBL to promote trade facilitation. The fifth section concludes.

II. RISE AND FALL OF TRADE-RELATED CONDITIONALITIES IN THE AGE OF GLOBALIZATION

Trade liberalization used to be featured strongly in conditionalities of structural adjustment lending by Washington-based international financial institutions, partly provided in response to financial crises in the emerging markets in the 1980s and the 1990s. Reduction of trade restriction, achieving the competitive exchange rate, abolishing barriers to foreign direct investment (that may improve market access for trade in services through commercial presence of foreign service providers³), and cutting market-distorting subsidies as part of public expenditure rationalizing were part of the typical prescriptions for developing countries’ policy reforms then known as the Washington Consensus (Williamson, 1990). Trade restrictions were thought to be a cause of misallocation of resources in general and adding anti-export-bias by limiting access to inputs in particular. Import licensing was replaced by tariffs, to allow for competition among domestic producers, and then tariff rates were reduced to induce competition with foreign suppliers.

² In this paper, the term “trade liberalization” is meant to include reduction or elimination of tariffs, quantitative restrictions, trade-related subsidies, or all other forms of trade-distorting measures on both goods and services.
³ The WTO’s General Agreement on Trade in Services classifies commercial presence in foreign markets as one of the four modes of supplies of service trade. Market access for foreign investors is often a subject of trade negotiations.
In the period up to 1997, the year of the Asian financial crisis, more than 50% of the economic policy reform programs supported by the International Monetary Fund (IMF) had trade-related conditionalities (Figure 1). Over 60% of the IMF’s trade-related conditionalities in the mid-1990s addressed tariffs and non-tariff barriers (IMF, 2005a). Relevant conditionalities under the IMF programs brought about tariff cuts (Busse & Vogel, 2023) and generally expanded trade, while performance varied depending on the country ownership of reforms and the type of arrangements (IMF, 2005c; Tang & Wei, 2009; Yoon, 2009). Almost 70% of the World Bank’s adjustment lending had trade components between 1985 and 1995 (Edwards, 1997), and the use of trade-related conditionalities once peaked in the late 1980s, whereby there were nine of them per loan on average (Figure 2). The World Bank’s trade-related conditionalities helped eliminate quantitative restrictions, mitigate broader nontariff barriers, correct exchange rate disequilibria, and reduce levels of import duties and export taxes (World Bank, 2006). Washington-based institutions were not the only IFIs that supported trade liberalization. In 1999, the Asian Development Bank (ADB) provided program lending under its trade, export promotion, and industry program for Pakistan, whereby both tariffs and nontariff measures of trade restrictions were substantially curtailed (ADB, 2004).

However, IFIs’ use of trade-related conditionalities once peaked, by around 2000 in the case of the IMF and the late 1980s in the case of the World Bank. There were two reasons for this development. First, substantial progress had already been made in unilateral reduction of tariff rates in most of
the developing world from the 1980s onward and critical importance to pose trade liberalization conditionalities once diminished considerably. The most-favored-nation tariff rate of low- and middle-income countries was nearly 50% on simple average in 1989, but it had declined to around 10% by 2015 (Figure 3). The state of globalization in terms of the world’s trade-to-gross domestic product ratio reached 61.1% at its peak in 2006, and developing countries that liberalized trade in the 1980s enjoyed rapid economic growth (Dollar & Kraay, 2001). Remaining trade-related conditionalities were mostly on trade facilitation or customs modernization, rather than trade liberalization.

Second, multilateral or regional trade negotiations and trade agreements appeared to have emerged prominently as alternative vehicles for trade liberalization among developing countries. Establishment of the WTO in 1995, the subsequent launch of DDA in 2021, and proliferation of preferential trade agreements led to a hope that trade liberalization for developing countries will be driven multilaterally and regionally. Typically, IFIs’ PBL supports unilateral structural reforms of a single member without trade reciprocity from the rest of the membership, and the relevance of conditionalities on such domestic reforms in budget and balance-of-payments support might have diminished. Instead, support to the WTO agenda through research and advocacy has become an important task for IFIs (IMF, 2005a, 2005b, 2009, 2019; World Bank, 2005; 2006).

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4 Necessity to include conditionalities for trade liberalization irrelevant to the macroeconomic crisis was also questioned in the context of the 1997 Asian financial crisis (Feldstein, 1998).

5 Policy-based lending is budget support or balance-of-payments support by international financial institutions, disbursed upon completion of agreed policy reforms by the borrower, known as conditionalities.
III. REVIVING AID FOR TRADE LIBERALIZATION IN THE AGE OF SLOWBALIZATION

Trade-related conditionalities under IFIs’ PBL did play certain roles to promote globalization in the 1980s and the 1990s and can be revitalized in the present circumstance of the world economy. After the global financial crisis in 2008–2009, the optimistic context that once justified a decline of conditionalities for trade liberalization seems to have disappeared almost entirely. The global economy entered the phase of slowbalization and geoeconomic fragmentation. The world’s trade-to-gross domestic product ratio stopped rising and have been hovering around 60% since 2008 (Figure 4). The broad trend of trade liberalization has also come to an end. The average MFN applied tariff rates of developing countries have not declined substantially below 10%, leaving the gap with that of developed countries with lower tariff rates. The economies that still pose two-digit percentage level of simple average tariff rates are predominantly developing countries. Yet, a focus in applied tariffs alone would cast a misleading picture of trade policies. According to the Global Trade Alert data, there have been 6,145 trade-distorting measures introduced after November 2008 across the globe (against only 1,879 trade liberalization measures), and only 7% of them are tariffs. Subsidies (excluding export subsidies), contingent protection, and export-related measures accounted for higher shares of 39.9%, 17.6%, and 13.8% respectively. In particular, subsidies are most frequently used instruments of trade distortion and deserve utmost concern (IMF, OECD, World Bank, and WTO, 2022). While developed countries adopted many trade-distorting industrial policy measures, so did a number of large developing countries and not all smaller developing countries were totally detached from this rising trend of trade distortion. Over 80% of the 196 economies surveyed introduced a higher number of trade-distorting measures than that of trade liberalization measures since 2009 and these include developing countries (Figure 5). Except where justified by both presence of market failure and absence of government failure, the state interventions bring about welfare losses to the countries that employ them. Trade-related conditionalities could become an effective instrument to reverse or prevent adoption of such market distorting measures.

In the meantime, partly due to the WTO members’ disagreements in negotiations on agriculture and nonagriculture market access, the DDA has also been deadlocked since 2008. Together with sector-specific negotiations and agreements in the WTO, trade-related conditionalities under PBL could make up for absence of DDA’s progress in broad areas of nondiscriminatory trade policy. Just like trade agreements, conditionalities under budget and balance-of-payments support can empower reformers within developing countries and catalyze their domestic political economy dynamins to advance structural reforms, where the ownership for the changes exists (Box). During the Uruguay Round in 1986–1994, developing countries made little market access commitments multilaterally beyond what was implemented unilaterally (Irvin, 2023) but, as per statistical analysis by Mike Finger, a former World Bank economist, they made more tariff cuts through the IMF and the World Bank programs (Hoekman and Winters, 2002). Thus, the experience shows that trade-related conditionalities for unilateral reforms by multilateral institutions could well supplement trade agreements that result from multilateral negotiations.

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6 This policy recommendation is directed only for developing countries that need BOP support or budget support as an important source of public finance or foreign currency reserves. For other countries, different solutions should be sought. One of such options could be to enhance the WTO’s Trade Policy Review Mechanism, to urge unilateral trade liberalization of the countries surveyed. See Takamiya (2024).

7 Global Trade Alert: https://www.globaltradealert.org/global_dynamics/day-to_0507/flow_all (accessed 7 May 2024).
Against the backdrop of slowbalization and the rise of industrial policy in the recent decades, aid for trade should reorient its focus back to trade liberalization by increasing the support level. One distinctive advantage of involving IFIs in trade policy-making is their expertise and coverage of broader areas of economic policy. Trade policy is closely related to neighboring areas of economic policies and, often, these should be best reformed in parallel or in well-designed sequences. For instance, tariff cuts should be pursued together with an increase of less distortive or less discriminatory form of taxation, such as value-added tax, to eliminate adverse impacts on fiscal revenues. Liberalization of trade in financial services should be packaged with enhancement of prudential regulations to ensure financial stability. IFIs have operations in areas like fiscal policy, public financial management, and financial sector reforms, and their members’ trade policy reform could be supported as extension of these existing works.

There are already some signs of such positive developments. In the period of fiscal years 2016–2021, the share of prior actions on industry, trade, and services under development policy financing by the World Bank Group has risen compared with the level for fiscal years 2011–2015 (World Bank, 2022). The IMF’s 2023 policy paper also calls for reinvigorating the Fund’s work on trade to address emerging challenges of global trade, while use of trade policy conditionality would remain limited (IMF, 2003). Attention to trade has also been picking up outside of the Bretton Woods institutions. ADB provided PBL to support Pakistan’s reform to cut tariffs, broader trade-related taxes, and nontariff measures through two subprograms implemented in 2019–2020 (ADB, 2022). In the areas of trade in services, market access for foreign financial institutions’ entries to the Philippines was eased under ADB’s capital market reforms program in 2016–2018 (ADB, 2019). Further efforts could be made to bring back trade liberalization into IFIs’ PBL agenda.
Trade-distorting measures, such as tariffs, quantitative restrictions, export subsidies, or voluntary export restraints, impose a deadweight welfare loss to importing countries, but in a manner that benefits producers and penalizes consumers. Since a smaller number of producers are better organized to lobby in pursuit of their vested interest than dispersed consumers, there is a limit for reformers within each country to advance trade liberalization with their autonomous efforts alone. The two strands of economic theories on trade agreements can explain how trade negotiations and agreements can shift the political economy dynamics of domestic trade policy-making in favor of liberalization. As shown below, these could be applicable to trade-related conditionalities of policy-based lending with some adjustments.

- **Commitment Theory.** Even if the reform-minded government announced prospective trade liberalization, such announcement may not always be perceived seriously by domestic business entities. In such a case, the business entities may not start necessary adjustment to shift resources from import-competing sectors in anticipation of future shocks. As a result, the government that worries about social consequence of trade liberalization may end up with deciding to abandon implementation of reforms in the future. Trade agreements can enhance credibility of the government's commitment for trade liberalization and help prevent this unfavorable scenario of trade policy-making. Just like trade agreements, conditionalities in the policy-based lending can function as a commitment device to enhance credibility of the government's resolve and catalyze implementation of structural reforms. Unlike the case of commitments in the multilateral trade agreements at the World Trade Organization, conditionalities by the international financial institutions are not backed by a similar dispute settlement mechanism, but they are nonetheless supported by financial assistance at least in the initial phase of implementation.

- **Juggernaut Theory.** Under the reciprocal trade negotiations, expansion of market access in the trading partners is conditioned upon opening of the domestic market of its own. In this setting, exporters lobby for further opening of domestic markets and act as a counterweight against import competing industries that opt for protection. Thus, the reciprocity helps mobilize export interests in favor of market opening, and that has a snowball effect for further liberalization. Unlike the case of trade agreements, conditionalities for reforms under policy-based lending does not require any trade reciprocity on the part of the membership. However, a borrowing country receives financial support (in the form of general budget support or balance-of-payments support) as a quid pro quo for reforms. Such external financing (possibly including funding to make up for revenues losses as a result of tariff cuts) may counterbalance “protection for sales” for election contributions by interest groups representing import-competing industries. Yet, IFIs should avoid “buying reforms” not backed by the country ownership and ensure that ownership exists from within the country.
Apart from these two theories on political economy of trade policy-making, the theory of terms of trade externality sets forth the merit of reciprocal tariff cuts to avoid the loss from trade wars. However, the practical relevance of the theory may be curtailed because of lack of awareness on terms of trade impacts of trade policy among policy makers. The presumed model of reciprocal trade liberalization does not apply to unilateral trade liberalization supported by conditionalities of policy-based lending.

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Source: Author.

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One of the earlier challenges against implementation of trade policy reforms initiated under PBL-supported programs was their reversal after completion of disbursement. A temporary suspension of trade liberalization could serve as a safety bulb when unforeseen influx of imports poses difficulties to adjustment in domestic resource allocation, as in the case of safeguarded under multilateral trade agreements (Bhagwati, 2004). However, permanent reverse of reforms would bring about lasting welfare losses. There could be three approaches to prevent this unfavorable scenario. First, support to trade liberalization should be provided in a long-term horizon with IFI’s successive engagements for progressive market opening. Fred Bergsten’s so-called “bicycle theory” prescribed that, to avoid policy reversal motivated by domestic vested interests, trade liberalization must keep moving without stopping (Destler and Noland, 2006). Second, the reforms must be owned by key policy makers within the country to be sustained even after disbursement. While conditionalities can catalyze country ownership in favor of reforms, they cannot create ownership. On this account, IFIs adopted existence of country ownership as prerequisite for PBL (IMF, 2002; World Bank, 2005). Third, after disbursement, part of conditionalities related to market access could be re-filled in the schedules of commitments on goods and services at the WTO. Once its dispute settlement mechanism is fully restored, incompliance with market access commitments can be subjected to powerful multilateral litigation, a prospect of which can help restrain attempts for policy reversal.

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The Appellate Body of WTO’s dispute settlement system is presently not functioning because of insufficient member appointments.
IV. BEYOND TRADE LIBERALIZATION—CONTRIBUTING TO TRADE FACILITATION

Notwithstanding a general decline of aid for trade for trade liberalization, external support for trade facilitation and other forms of measures to cut trade costs has been expanding (World Bank, 2011). The WTO’s Trade Facilitation Agreement linked its implementation by developing countries to their implementation capacities. IFIs’ lending operations backed by technical assistance can contribute to its rollover and related initiatives to smoothen trade flows. In fiscal years 2006–2017, the World Bank supported 221 projects of trade facilitation (for about $4.8 billion). Among them, 116 were PBL focusing on improving risk-based management, streamlining standards, and simplifying rules (World Bank, 2019). Two-thirds of the World Bank’s development policy financing operations between July 2015 and June 2021 had at least one policy action to establish the enabling business environment, and deepening integration with the global economy through trade facilitation and logistics was one of the most cited policy objectives. Such PBL was effective and helped improve the borrowers’ policy performances measured by the country policy and institutional assessment (World Bank, 2022).

Over an extended period, ADB has been providing a series of PBL for trade facilitation as part of South Asia Subregional Economic Cooperation (ADB, 2017). Further to the trade facilitation program for Bangladesh, Bhutan, and Nepal implemented in 2013–2014, another program for customs reforms and modernization for trade facilitation was approved for Nepal in 2017 to help the country fulfill its commitment under the WTO’s Trade Facilitation Agreement and related international standards on customs. The subsequent customs and logistics reform program, originally approved in 2023, is expanding the government’s efforts for trade facilitation to the logistics sector. Another budget support to implement the Trade Facilitation Agreement was approved for Bangladesh as part of the integrated trade facilitation sector development program in 2022. ADB’s trade and competitiveness program for Pakistan supported operationalization of the country’s single window, in support of Trade Facilitation Agreement implementation. Trade facilitation was also featured in ADB’s PBL aimed at improvement of the investment climate and the business environment in Cambodia and Indonesia.

V. CONCLUSION

Trade policy reforms should be mainstreamed back into the design of aid for trade to developing countries. Presently, external financial support conditioned upon trade policy reforms accounts for only a negligible share of trade-related development assistance. After the golden age of the Washington Consensus in the 1980s to 1990s, the use of conditionalities aimed at trade liberalization in IFIs’ PBL has declined. However, the present context of slowbalization and geoeconomic fragmentation of the global trading environment warrants revitalization of aid for trade to deter expansion of trade-distorting measures prevalent across the globe. In the meantime, a rising profile of trade facilitation is a welcome development. Trade-related conditionalities under PBL could work in a manner similar to commitments in the trade agreements. Such potential could be utilized proactively to preserve the open global trading environment and help it withstand the present headwind against it and maximize the benefits of globalization in the developing world.
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Mainstreaming Aid for Trade for Structural Reforms in the Changing Landscape of the Global Economy

Today’s global trade landscape requires all multilateral institutions to work together with the World Trade Organization (WTO) to restore the open trade regime. International financial institutions (IFIs) can revitalize use of trade-related conditionalities in their policy-based lending to increase gains from trade for developing countries. Like the WTO’s multilateral trade negotiations and agreements, IFIs’ balance-of-payments and budget support, along with well-designed conditionalities, could catalyze country ownership of reforms by empowering reformers in domestic policy-making and advance trade liberalization. Such potential should be explored to preserve the open global trading environment that maximizes the benefits of globalization in the developing world.

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ADB is committed to achieving a prosperous, inclusive, resilient, and sustainable Asia and the Pacific, while sustaining its efforts to eradicate extreme poverty. Established in 1966, it is owned by 68 members—49 from the region. Its main instruments for helping its developing member countries are policy dialogue, loans, equity investments, guarantees, grants, and technical assistance.