

## **Linkages between International Trade and Financial Markets: Mapping the Issues**

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My PhD dissertation topic was trade creation and trade diversion in the European economic community. In that research, completed in 1967, I applied a rudimentary disaggregated, partial-equilibrium methodology focused on trade flows. Today's approaches exploit computable general equilibrium (CGE) models, but they share an almost exclusive focus on effects on economic activity, on trade and the real economy rather than on finance and financial markets, and, in particular, not vice versa. The gap between trade and finance is large.

Why do we have this gap? I suggest three reasons: institutional, philosophical, and technical. The institutional reason is that the field of international economics these days has two distinct branches: trade and finance. In the 1960s, they were more integrated. I wrote my trade dissertation under Bob Triffin, a prominent international monetary economist; Dick Cooper, whose field was international finance; and Steve Hymer, whose field was foreign investment and development. (I myself have spent most of my career working on international financial issues.) The philosophical reason is that in most of our models money and finance are neutral. The technical reason is that CGE models and their more sophisticated cousins, dynamic stochastic general equilibrium (DSGE) models have rudimentary financial sectors. In part the reason is because finance as a field has not yet generated useful regularities for macroeconomic models. But there is a problem with these models: they must have a well-defined equilibrium in order to be solved.<sup>1</sup> On the other hand, we know that financial markets often behave as if there is no equilibrium or no nearby equilibrium, and we have recently relearned that financial market disruptions and the financial side of the economy can have important influences on the real economy. Financial market disruptions may be temporary, but temporary can last for years.

Even for those who view economic activity and finance as two sides of the same coin, the question is: Which dominates?

In the domestic context, does the real economy dominate the financial system or vice versa? If a crisis affects both, as has been the case recently, should the real economy be fixed first or the financial system? Can we reform the financial system and its regulation without adversely affecting the performance of the real economy?

In the international context, transactions involve the current account and the financial (formerly capital) account. Again, does the financial account drive the current account, or vice versa? Can we think about the factors affecting the current account (growth rates and exchange rates) separately from the factors affecting the financial account (interest rates and portfolio

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<sup>1</sup> There are exceptions and many modelers recognize this shortfall, but as a rule my generalization holds.

preferences)? Can we curb the excesses of the financial account (volatile capital flows) without adversely affecting the current account (global imbalances)?

The general answer to these questions is that both real and financial activities are relevant to the health of our economies and the international economic and financial system. We live in a yin yang world. Yin yang is defined in Wikipedia as “complementary opposites within a greater whole.” It may be that one or the other element is dominant or more important at a particular point in time, but both are equally important over time—like it or not.

Against that background, I will sketch some thoughts loosely organized under four headings: policymaking, investment and government policies, currencies and trade, and linkages.

### **Policymaking**

In most countries, policies on international trade and finance are developed in separate silos. Countries have trade ministers and finance ministers. The trade ministers interact via the World Trade Organization (WTO) and in a plethora of regional arrangements. The finance ministers interact via the International Monetary Fund (IMF) and fewer regional arrangements, most prominently in the euro area. Policies and institutions generally are not integrated. At the international level, institutional rivalries are unresolved such as jurisdiction over investment and capital flows. At the domestic level, similar rivalries are settled by the leaders of the respective governments. As a generalization, either the trade minister or the finance minister wins all the battles though, in some countries, outcomes are more difficult to predict.

For example, in China today there is a debate between the trade ministry, which is focused on maintaining employment and the growth of employment in export industries, and the finance ministry and central bank, which are focused on the health of the overall economy and financial system and the economic, financial, and political consequences of continuing to add to China’s hoard of foreign exchange.

Occasionally, trade concerns and financial concerns come together. They were both present when the United States closed the official gold window in 1971, in part because of the use of a tariff surcharge in that context to exert leverage over other countries to raise the values of their currencies. However, trade concerns dropped out of the subsequent negotiations over reform of the international monetary and financial system though arguably the Tokyo Round of trade negotiations was a collective policy response to pressures on the trading system exerted by the collapse of the Bretton Woods regime of exchange rates.

Trade concerns reemerged in the mid-1980s in the context of the super-strong US dollar, various measures aimed at limiting exports, and a palpable sense of rising protectionism. One response was the Plaza Agreement in September 1985 designed to appreciate other major currencies against the dollar. Again, it can be argued that the Plaza helped to usher in the Uruguay Round of trade negotiations that resulted in the transformation of the General Agreement on Tariffs and Trade (GATT) into the WTO. Neither of these examples should be viewed as the finance agenda driving the trade agenda though there may have been a bit of yin yang.

More recently one finds in the communiqués of the G-20 leaders ritualistic commitments to complete the Doha Round of trade negotiations. Paragraph 28 of the Leaders Statement at the Pittsburgh Summit reads, “We will fight protectionism. We are committed to bringing the Doha Round to a successful conclusion in 2010.” But the result has been inaction on Doha. On protectionism, it could have been worse, but by one count,<sup>2</sup> the G-20 countries through February 2010 had put in place more than 250 final protectionist actions. The expected extended period of high unemployment is likely to expand that list.

Thus, trade and finance coexist in the policy arena, and one area may be dominant over time, for some countries, or from time to time for the system as a whole, but the two areas are not integrated in our thinking.

### **Investment and Government Policies**

Mirroring policymaking patterns, an ambiguous separation exists between the WTO and the IMF with respect to investment and government policies with respect to capital flows. The GATT (now WTO) and IMF are siblings separated at birth, each with its own terms of reference. When it comes to investment issues, and the roles of the public and private sectors in those activities, the WTO encompasses agreements on Trade-Related Investment Measures (TRIMs) and the General Agreement on Trade in Services (GATS). These elements focus primarily on establishment or stock issues, not on financial transactions or flow issues. These distinctions are often lost in the rhetoric. The WTO’s involvement in this area, known as the Singapore issues, is controversial, and they have been dropped from the Doha Round agenda.

The IMF, for its part, focuses on issues of capital flows, but its mandate in this area is also controversial. In the late 1990s recognition of the IMF’s outdated mandate, along with concerns about the WTO getting into the IMF’s turf, led to consideration of an amendment to the IMF Articles of Agreement to update and clarify the IMF’s role in this area. That effort foundered on the Asian financial crises and perceptions, mistaken in my view, that the crises had been precipitated by a rush to capital account liberalization promoted by IMF policy.

In the context of the global economic and financial crisis of 2007–09, the issue of volatile capital flows is once again on the agenda, including the agenda for reforming the international monetary system. In my view, the possibility of amending the IMF Articles of Agreement as they apply to capital flows and capital controls should be reconsidered. The process should start with a full-fledged examination to see if there is enough common agreement. The principal rationale for collective action is that both flows and controls generate externalities.

If there is sufficient agreement, I envisage an amendment with three components. First, the amendment should state the long-term goal of complete freedom of capital movements among countries, along with appropriate prudential regulations internally and globally, analogous to the situation within countries. There should be no timetable, explicit or implicit, to achieve this goal. In terms of the ultimate objective, I have never been convinced by the view espoused by Jagdish Bhagwati, perhaps writing for a majority of trade economists, that (in contrast with free trade)

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<sup>2</sup> Global Trade Alert, 2010 at [www.globaltradealert.org](http://www.globaltradealert.org).

freed capital movements have no redeeming social value.<sup>3</sup> Second, the amendment should guide national policies in terms of both the rights and the responsibilities of IMF members. For example, controls should be permitted but as much as possible they should be applied on a nondiscriminatory, national treatment basis. Third, the amendment should describe and prescribe the role of the IMF management, staff, and members in conducting surveillance over capital flows and controls.

In my view, trade, investment, and financial flows are part of an integrated whole. Moreover, governments and governance are also part of the mix. An important illustration of these interactions is sovereign wealth funds (SWFs). These government-controlled pools of assets normally include international assets. The SWFs raise issues of the role of governments and also reveal tensions about the shift in economic and political influence in the global economic and financial system from the North Atlantic to the rest of the world. I have urged the adoption of a set of best practices for SWFs. To this end I devised an SWF scoreboard to provide a benchmark for such a standard. The Santiago Principles (or Generally Accepted Principles and Practices of SWFs) are an important and impressive first step toward establishing a strong standard, but my emphasis is on the word “first.”

I am far from an expert in the area of international investment policies, but I am attracted by an international investment treaty as the ultimate goal. It should be accompanied by enforcement mechanisms presumably lodged in the WTO. Getting to that point will not be easy. It will require that policies and policymaking on trade and finance come together to a substantially greater degree than we have seen in recent decades.

## **Currencies and Trade**

With respect to the interaction of currency policies with trade policies, the global economic and financial system faces twin tensions. One tension is between those who view exchange rates and exchange rate policies exclusively as mechanisms to control the current account, trade positions, and impacts on real economies and those who view exchange rates and trade and current account positions as joint outcomes of multiple policies and influences. A second tension derives from an exclusive focus on the financial account, the financial sector, and financial markets with respect to issues such as the composition of capital flows and the international role of the US dollar or euro; the consequences for and the behavior of the current account are ignored.

The trade regime and its outcomes focus largely at the microeconomic level, and the currency regime and its outcomes focus largely at the macroeconomic level. The regimes are in separated silos, but they overlap. For example, some have argued recently that Chinese exchange rate policy should be brought to the WTO under Article XV (4) of the GATT, which states “Contracting parties shall not, by exchange action, frustrate the intent of the provisions of the Agreement” or as a WTO-prohibited export subsidy. I am inclined to agree with my colleague Gary Hufbauer and his coauthors who have argued that such a case would bring the WTO onto the IMF’s turf, would be vigorously resisted by the finance ministers, and would likely fail with,

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<sup>3</sup> Jagdish Bhagwati. 1998. The Capital Myth. *Foreign Affairs* (May/June).

in my view, adverse consequences for the reputation and standing of both institutions.<sup>4</sup> I disagree with another colleague Arvind Subramanian and his coauthor who argue that trade ministers can and should be trusted vigorously to use the authority and powers of the WTO in this area and to take the threat from currency undervaluation more seriously.<sup>5</sup>

Who is right in this debate is not particularly relevant to our discussions here. The point is that trade and finance (in the form of currency policies) too frequently are treated as distinct and separated policies, for better or for worse. I would submit that the separation is for worse, but the situation is not going to be resolved by transferring jurisdiction between international organizations. The answer is cooperative integration, not warring separation.

The current European drama illustrates an additional dimension in the nexus of currencies and trade. Oversimplifying somewhat, in the ongoing aftershocks from the 2007–09 global economic and financial crisis, the policies of Greece and potentially several other members of the European Union and the euro area have contributed to an abrupt and substantial weakening of the euro. If the euro's weakness on real effective terms is sustained, to say nothing of being intensified, the likely result will be the emergence of a significant current account surplus in the euro area, perhaps on the order of \$200 billion to \$300 billion, around 2 percent of euro area GDP. The surplus is likely to be even larger if, within the euro area, other member countries do not compensate for the shortfall in domestic demand over the next several years coming from Greece and other members that necessarily have to tighten dramatically their fiscal policies. The result will be to open another front in the debate about global imbalances and another challenge to achieving the G-20 leaders' September 2009 commitment in Pittsburgh to "act together to generate strong, sustainable, and balanced global growth. . . [and] a durable recovery that creates the good jobs our people need." Moreover, euro weakness will do nothing to correct the trade and competitiveness imbalances within the euro area.

Thus, growth—balanced growth—becomes another variable in the yin yang of trade and finance, sometimes an independent variable and sometimes a dependent variable in the nexus of trade and currency policies. In the current context, weakness of the euro, in principle, might be addressed via coordinated exchange market intervention in support of the euro. The effectiveness of such a policy response is an open question. The answer to that question depends on how one views the behavior of financial markets and the determinants of exchange rates. I will not pronounce on that topic. My purpose is primarily to illustrate some of the neglected interactions of our thinking about trade and finance with other policies and objectives.

## **Linkages**

My basic argument is that the linkages between trade and finance in the global economy and policymaking are stronger than present academic thinking and institutional arrangements appreciate.

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<sup>4</sup> Hufbauer, Gary Clyde, Yee Wong, and Ketki Sheth. 2006. *US-China Trade Disputes: Rising Tide, Rising Stakes*. Policy Analyses in International Economics. Washington: Peterson Institute for International Economics.

<sup>5</sup> Subramanian, Arvind, and Aaditya Mattoo. 2009. Currency Undervaluation and Sovereign Wealth Funds: A New Role for the World Trade Organization. *World Economy* 32, no. 8 (August).

One important reason for the under appreciation is the increased globalization over the past six decades. First, the number of relevant international players has increased at the governmental and private levels. In effect, the economic and financial systems of the North Atlantic victors in World War II have spread around the world even as the influence of those victors has waned. Second, barriers to trade and, even more so, capital flows have been substantially eliminated. The global economic and financial crisis of the past several years has demonstrated that no country or part of the world is immune from the effects of economic and financial developments in another country of significant size in another part of the world. Real economies and financial systems have proved to be more integrated globally than anyone thought would be the case.

For the academic, and I would hope the policymaker, the crisis is producing a wealth of information that can be exploited to learn lessons for practical policymaking. A recent example is the relative influence on the collapse of global trade in late 2008 and early 2009 of real economic factors (economic downturns) and financial factors (lack of trade finance). At first, financial factors were thought to have been dominant, but more recent research suggests that real factors played a more significant role. However, the point is that both were and are relevant.

My concerns are that, first, the wrong lessons will be learned from the recent crisis and the globalization that fostered its spread and, second, individual countries and regions will turn inward and erect new barriers. In this context, and relevant to Europe, I would submit that, unless carefully monitored, regionalism and bilateral arrangements are a fundamental threat to globalization because they imply that different rules and standards apply to different countries. However, that is an additional topic for another discussion.

Attitudes and perceptions are important to sustaining the institutions of the global system with respect to trade and finance. Those institutions are being pulled in many directions. We have the WTO and the near-dormant Doha Round of trade negotiations. We have the IMF, which has been resuscitated by the crisis but faces important issues in terms of financial support, governance, and substantive relevance once the crisis has passed. We also have the Financial Stability Board with its expanded membership and mandate under the auspices of the Group of 20. Each institution has a role to play in limiting the fragmentation of the global system in the period immediately ahead. Moreover, if the leaderships, including by the systemically important members, of these institutions are unable to work together effectively in our globalized world, we will all be worse off. The analytical and policy challenges are huge and the academic community can make an important contribution toward integrating international trade and financial markets in their studies and policy recommendations.