probably have paved the way for the turbulences. In the past there has been a series of macroeconomic variables whose behaviour in the year prior to currency turbulence differed markedly from their behaviour in tranquil periods. An over-valuation of the currency, low levels of foreign exchange reserves and a below-average export growth were symptomatic of periods prior to typical turbulences. Moreover, Frankel and Rose,[27] who were themselves rather surprised by their (non-) findings, conclude that "... neither current account nor government budget deficits appear to play an important role in a typical crash ...", statistical evidence is provided that both variables in fact do increase economies' vulnerability to speculative attacks. In many cases, too, a sharp expansion of domestic lending, and almost as a consequence thereof, high inflation differentials, may also have shared responsibility. Above and beyond that, susceptibility to speculative attacks also seems to increase whenever interest rates in the United States rise, impelling internationally oriented investors to re-think their global portfolios, for one thing, and impairing the creditworthiness of the emerging markets due to a rising debt burden, for another.

It might be quite ambitious, though, to see such studies on the behaviour of macroeconomic variables prior to currency turbulences as an appropriate starting-point for establishing an early warning system to avoid future turbulences in the foreign exchange markets. A basic problem in setting up an early warning system may lie in the fact that international financial market players, if given such an instrument to forecast currency turbulences, will change their behaviour, meaning that the relationships of the past would not be able to be carried over into the future. To the extent that this theoretical critique does not fully apply in practice, the empirical model may support the examination of the vulnerability of an emerging market to currency turbulences. After all, the study was able to show that the financial market players generally did not act out of tune with the fundamentals in the past. It has identified a number of macroeconomic variables to which political decision-makers would have to pay attention when striving to minimise the vulnerability of their currencies to speculative attacks.

[27] J. A. Frankel, A. K. Rose, op. cit., p. 365.

Karen McCusker*

Are Trade Restrictions to Protect the Balance of Payments Becoming Obsolete?

With the removal of exchange controls and other restrictions to capital mobility, the need for, and the use of, import restrictions for balance-of-payment reasons, as provided for under GATT Articles XII and XVIII:B, has diminished. Since a recent WTO ruling also seems to have put a stop to developing countries' using the ambiguity of treaty language to justify measures designed to protect their domestic industries, there is reason to expect that trade restrictions justified with a foreign exchange crisis will finally fall into disuse.

The WTO, formerly the GATT, is the source, keeper and final arbiter of basic rules governing international trade. As a legal treaty, based on economic principles, it is subject to juridical interpretation. The ultimate form of such interpretation is through trade disputes, based on alleged infringements, which are settled either by a panel or the WTO Appellate Body.

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Before cases are brought to the WTO, there are various forms of "surveillance" implemented to ensure that member governments are in conformity with their obligations. One form of such surveillance is the work performed by the Committee on Balance-of-Payments Restrictions.

For the last several decades, this Committee has overseen the use of the exception to the GATT obligations which allows for the use of import restrictions applied "to safeguard the level of foreign

exchange reserves"; these are contained in GATT Articles XII and XVIII:B. The right of member governments to use import restrictions to address macroeconomic problems was modified by the understanding that such measures would be temporary, to solve cyclical problems, and acceptable only in "critical" situations. Article XII:2(a) states that import restrictions "shall not exceed those necessary (i) to forestall an imminent threat of, or stop, a serious decline in monetary reserves" or (ii) ".. to achieve a reasonable rate of increase in its reserves". What constitutes a "critical" balance-of-payments problem is defined, if at all, more broadly for developing countries. Under Article XVIII:B, the "threat of a serious decline in reserves" is conditioned by the additional phrase "to ensure a level of reserves adequate for the implementation of its programme of economic development", a concept subject to considerable interpretation. In addition, a Member is not required to remove restrictions "on the grounds that a change in its development policy would render them unnecessary." This bestows a more permanent quality to the use of trade restrictions and relates the balance of payments disequilibria to structural rather than cyclical factors.[1]

Vague GATT Provisions

It is the orthodox view that a balance-of-payments deficit arises from a basic macroeconomic disequilibrium between output and expenditure, an excess of expenditure over savings.[2] The GATT provisions recognize this fact, tacitly, by referring to the need to consult on "alternative measures to restore equilibrium", but there is no legal duty on the government to explore these alternative measures, nor do the rules require that alternative measures be applied in order to back up trade restrictions.[3] Due to the vagueness of the rules, differences in political ideologies in the Committee and the, sometimes understandable, resistance of countries to give up what they consider issues of sovereignty to a multilateral force, it has at times been difficult to differentiate genuine balance-of-payments safeguards measures from import restrictions designed to protect domestic industry.

The Committee, in its periodic consultations with the country maintaining the measures, is expected to make two determinations: whether there is a balance-of-payments problem and whether the trade measures are appropriate. On the latter point, the WTO Understanding on the Balance-of-Payments Provisions of the GATT 1994 emphasized the principles that measures should be price-based, temporary and applied across the board (to prevent disguised sectoral protection).[4] Even price-based measures will not address the root causes of the macroeconomic disequilibria reflected in the external account, whereas policies which have a direct impact on savings or investment will have a more lasting effect on the balance of payments. Members of the WTO, whose brief has been restricted, under the GATT, to trade practices, have been timid about embarking on a full-fledged discussion of alternative measures, leaving macroeconomic policy prescription to the IMF.

When a Member consults in the Committee a number of conditions are taken into account before the Committee arrives at conclusions. In assessing the balance-of-payments position and prospects, while the GATT Articles specifically refer to reserves, other factors are discussed including, inter alia, the rate of growth of overall economic activity, as well as imports and exports, the severity of the current account deficit (i.e. its share in GDP) equal to the dissaving in the economy, debt servicing obligations and the available financing. A country's international creditworthiness, as an indicator of the overall health or risks of the economy, may be considered. The trend in and level of reserves, as a proportion of imports or, sometimes, short-term debt, is the focal point of the assessment, although the composition of reserves may also be brought into the equation. With intensified integration of global financial markets, concern has been raised about the vulnerability of

[1] R. Eglin: Surveillance of Balance-of-Payments Measures in the GATT, in: The World Economy, Volume 10, No. 1, March 1987, p. 23.

[2] A typical balance-of-payments crisis might evolve as follows: in the process of growth or development, import demand, a component of aggregate demand, will surge to such an extent that the trade balance is negatively affected and foreign exchange reserves are drawn down to pay for this excess of expenditure over output. The same situation, incidentally, may result from an overvalued real exchange rate. A growing current account deficit (savings-investment gap) may be an early warning signal of a decline in reserves, as demand for foreign currency exceeds supply which savings (foreign or domestic) cannot adequately compensate. On the other hand, a country may run a trade or current account deficit for years without having what is known as a balance-of-payments problem, because it has other ways of ensuring an adequate level of reserves; in other words, its trading partners are willing to finance the deficit. Ultimately, the sustainability of current account deficits (or foreign borrowing) rests on whether foreign investors believe a country will eventually be able to generate a stream of net export earnings or adequate domestic savings sufficient to service and repay its external debts.

[3] R. Eglin, op.cit.

[4] Articles XII and XVIII:B were amplified by detailed consultation procedures introduced in 1970, by "simplified" procedures for developing countries established in 1972 and by the 1979 Declaration of Trade Measures taken for Balance-of-payments Purposes, which extended the GATT examination of the balance-of-payments provisions from quantitative restrictions to all trade measures.

short-term private capital movements to sudden reversals, eroding reserves. These can form a sizable proportion of capital inflows especially where an exchange rate may be overvalued. Although the IMF is called upon to "determine what constitutes a serious decline in monetary reserves ... or a very low level of reserves ..." and thus to indicate the balance-of-payments justification of the import restrictions, the modus operandi of the WTO, consensus, permits governments to avoid concluding whether there is a balance-of-payments problem or not.

Shift Towards Open Markets

Since the founding of the GATT, the world economy has come a long way: trade in goods has multiplied seventeen times since the end of World War II, the international monetary system has been delinked from the gold standard and flexible exchange rates were introduced. Most importantly, capital markets have been liberalized and increasingly integrated, allowing for improved global allocation of savings and the inflows, if unimpeded, which will adjust a country's balance-of-payments. As governments have become more enlightened in the last few decades, not least through successive rounds of multilateral trade negotiations, and, in the last decade of the twentieth century, the collapse of communism, faith in open markets has become, by and large, pan-national.

Ever since the Tokyo Round (1974-79), there has been a growing emphasis on the recognition that trade restrictions do not resolve balance-of-payments disequilibria. Already in the 1970s, governments agreed that a timetable should be presented, "whenever practicable" and expanded the coverage of import restrictions to explicitly encompass import surcharges. The 1980s saw a significant shift in developing countries' ideologies from protected to open markets. Dozens instituted trade, payments and investment liberalization policies as the conventional wisdom took root. With the removal of exchange controls and other restrictions to capital mobility, the use of trade policy to influence macroeconomic variables has declined. In tandem, the use of, or recourse to, import restrictions justified for balance-of-payment reasons has diminished. In 1991, the largest Latin American countries, Argentina, Brazil and Colombia, stopped applying Article XVIII:B, followed by Peru in 1992.

Argentina, for one, adopted a wide array of import restrictions in the early 1980s but introduced the Austral Plan in 1985 which focused on fiscal reform, price and wage freezes and a dollar-linked exchange rate regime. While there were adjustment pains in the first few years, annual budgets continued to emphasize privatization, improved tax collection, reducing the budget deficit and reform of the financial system, including an overhaul of regulation and supervision. In December 1989, Argentina adopted a freely floating exchange rate and continued with its stabilization policies and its privatization programme which contributed to a considerable reduction in domestic debt and growth in foreign investment. Meanwhile, it reduced the coverage of its import licensing and eliminated its residual balance-of-payments measures in 1991, although reserves were still fragile by standard measures.

Tightened Balance-of-Payments Provisions

During the Uruguay Round negotiations, rules were created and adapted to meet the changes of the global economy. In 1989, the United States and Canada argued that the solution to external imbalances was a combination of exchange rate adjustment and policy reform, but the developing countries, considering that Article XVIII:B was their sole enshrined form of "special and differential treatment" objected to any major modifications to the balance-of-payments provisions.[5] Nevertheless, the WTO Understanding did tighten up the balance-of-payments provisions, *inter alia*, mandating the submission of a timetable for phase out of import restrictions, subject to improvement in the balance-of-payments position. The Understanding also stipulates that a developing country, except for the least developed, may not consult under "simplified" procedures more than twice in succession. Simplified procedures (as opposed to "full" consultations) in which virtually no discussion takes place in the Committee reduces the surveillance process to a meaningless routine. Under these procedures, the Committee simply concludes, on the basis of documentation, that the country is meeting its obligations or, if there is a call for additional information on either the balance-of-payments situation or the measures, schedules full consultations in the next round.[6]

Since the establishment of the WTO, success, gauged by the willingness of Members to comply with the provisions of the WTO regarding the use of restrictions taken for balance-of-payments purposes,

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[5] J. Croome: Reshaping the World Trading System, World Trade Organization, 1995.

[6] Consultations are held every two years for developing countries, every year for countries consulting under Article XII.

has been measurable. The 1994 Understanding strengthened the provisions giving more bite to the consultation process: for example, countries applying quantitative restrictions are asked to justify why they are not using price-based measures, are expected to announce timetables for eventual elimination of the restrictions and come under severe criticism from their trading partners if the restrictions are applied only to certain products or sectors.[7] Compared to the mid-1980s when seventeen countries were using Article XVIII:B, by 1998, there were only four, the latter presenting particularly difficult cases where political instability and poor governance had interfered with the process of liberalization and structural adjustment. By the end of the decade, all but one was in the process of removing its restrictions according to a pre-announced timetable.

The United States vs. India

India, which had been the longest standing user of Article XVIII:B, maintained a restrictive import regime for decades, although the provisions are clear that restrictions shall be progressively relaxed as conditions improve and eliminated when conditions no longer justify their maintenance.[8] In the second half of the seventies, the current account was continually in surplus and between 1980 and 1985, the economy grew solidly, by 5.4 per cent per annum.[9] In 1984, India stated, during simplified consultations where no "exchange of views" takes place, that "although the balance of payments position has shown signs of improvement in recent years, it is feared that India may face external financing problems in the medium and long term."[10] In 1987, the Committee found the reserve position relatively comfortable and some Members did not accept the balance-of-payments justification. Following a severe economic crisis, when reserves fell to one month of imports at the end of 1990, the government began to adopt reform policies including a limited dismantling of quantitative restrictions on imports. In another "surveillance" forum, the GATT Secretariat noted that "maintained for balance-of-payments reasons, these licenses substantially protect domestic producers from import competition".[11] In December 1995, the IMF commented that quantitative restrictions on a large number of consumer goods had hindered the development of this sector and that the transition to a tariff-based import regime could be accomplished in two years. It recommended a phasing out process given the potential volatility of private capital inflows and to give domestic industries enough time to adjust.[12] In January 1997, the IMF stated that there was no threat of a serious decline in reserves and that reserves were not inadequate: reserves were at a "comfortable" level of five months of import coverage and sizable relative to short-term debt. Still, it took until mid-1997 before a timetable was presented, one many trading partners considered too long given that there were no balance-of-payments grounds for the restrictions.

Failing to get satisfaction in the Committee, in November 1997, the United States requested the establishment of a dispute settlement panel, claiming that India's import restrictions were inconsistent with India's obligations under, *inter alia*, Article XVIII:11. Article XVIII:11, whose main thrust is that restrictions must be eliminated once conditions no longer justify their maintenance, contains a number of caveats which required interpretation. For the convenience of the reader the text is reproduced here:

"In carrying out its domestic policies, the contracting party concerned shall pay due regard to the need for restoring equilibrium to its balance-of-payments on a sound and lasting basis and to the desirability of assuring an economic employment of productive resources. It shall progressively relax any restrictions applied under this Section as conditions improve, maintaining them only to the extent necessary under the terms of paragraph 9 of this Article and shall eliminate them when conditions no longer justify such maintenance; Provided that no contracting party shall be required to withdraw or modify restrictions on the ground that a change in its development policy would render unnecessary the restrictions which it is applying under this Section."

An Ad Note to Article XVIII:11 reads: "[t]he second sentence in paragraph 11 shall not be interpreted to mean that a [..member..] is required to relax or remove restrictions if such relaxation would thereupon produce conditions justifying the intensification or institution, respectively, of restrictions under paragraph 9 of Article XVIII."

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[7] In 1996, Tunisia was faulted for continuing its discretionary licensing for imports of motor vehicles, a sectoral measure seen as having little impact on the conservation of foreign exchange. A year later, Tunisia agreed to phase out import licensing on motor vehicles within three years.

[8] Article XVIII, paragraph 11.

[9] GATT: Trade Policy Review of India, Geneva, December 1993.

[10] GATT, BOP/245, Add.1, 15 May 1984.

[11] GATT: Trade Policy Review of India, Geneva, December 1993, Volume I, p. 89.

[12] World Trade Organization, Report on the Consultation with India, WT/BOP/R/11, 23 January 1996.

The WTO Ruling

The Panel examined the criteria which justify the use of such restrictions and considered that the criteria of Article XVIII:9 (a) and (b) were not met, i.e. that there was no balance-of-payments problem. Furthermore, the Panel considered that the probability of the event that a removal of restrictions would produce a decline in reserves to inadequate levels was not high enough to justify continued imposition. The Panel considered that the Ad Note should not be interpreted on the basis of a general possibility of worsening of balance-of-payments conditions after the measures have been removed ... as it could almost always be argued that there exists a risk of worsening of balance-of-payments conditions at some time in the future.[13] The Panel goes on to note that the problem of structural adjustment to import competition is not a justification for balance-of-payments measures; for these situations other provisions are available.[14] Thus, the indefiniteness of the period in which a developing country could maintain import restrictions on balance-of-payments grounds was greatly clarified via this legal decision.

According to the second sentence of Article XVIII:11, India cannot be required to change its development policy in order to render balance-of-payments measures unnecessary. If by development policy is meant domestic policies, then it should be read in the context of the first sentence of XVIII:11: "[i]n carrying out its domestic policies, the contracting party concerned shall pay due regard to restoring equilibrium on a sound and lasting basis..." which implies that trade measures are only a stop gap to allow domestic policies designed to redress the internal imbalance between income and spending over the longer term to come into effect.

Considering the IMF's opinion that the external situation could be managed using macroeconomic policy instruments alone, the Panel found, and the Appellate Body upheld, that such policy advice did not imply a change in development policy. The Panel, however, differentiated "development policy" as referring to structural, sector-specific measures, from macroeconomic policy. This rather tortured hair-splitting is a result of the ambiguous and even contradictory language of paragraph 11 which begs the question of what the drafters meant by development policy. It may be safe to assume that the reason for this proviso was simply to emphasize that in spite of other adjustment policies undertaken which could reduce pressure on the balance-of-payments, the use of trade restrictions was not circumscribed as long as the balance of payments problem existed.

The End of an Era?

As a result of the first WTO case to interpret the balance-of-payments rules, India will now be dismantling its licensing system two years ahead of schedule, eliminating all import restrictions by April 2001. With this action, it seems an entire era is coming to an end, when developing countries could use the ambiguity of treaty language to protect their local industries. Yet, the writing has been on the wall for some time. In spite of the serious economic crisis in Asia and its contagion effect spreading to other continents, policy-makers have markedly refrained from imposing direct restrictions on imports in the aftermath. Aware that the growing importance of world trade and capital flows may lead to increased volatility if safeguards are not adequate, the IMF proposed that countries' reserves be increased and in December 1997 established the Supplemental Reserve Facility; financing is linked to "reasonable expectations" that strong adjustment policies will be implemented. Even more recently, the IMF has cautiously condoned capital controls; resort to restrictions on merchandise trade is likely to seem irrelevant when the underlying transactions can be directly addressed in cases of instability. Scope for such action has been foreseen in the GATS (General Agreement on Trade in Services) although since the prudential carve out on financial flows is very wide, the balance-of-payments clause may never be invoked.

The trend away from quotas and to tariff-type measures is strongly entrenched; governments, particularly transition economies, are likely to resort to temporary import surcharges as they and other new entrants to the multilateral trading system overhaul and modernize their institutional frameworks and banking systems. Where free markets have a more tenuous foothold, import restrictions may again become a short-term remedy as political instability slows the course of alternative reforms. Still, one can hypothesize that trade restrictions to cope with a foreign exchange crisis will fall into disuse as the development process culminates in the use of more suitable policy instruments, including the appropriate exchange rate regime.

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[13] India - Quantitative Restrictions on Imports of Agricultural, Textile and Industrial Products, WT/DS90/R, 6 April 1999; para 5.199.

[14] Ibid., para 5.208.