SM/88/166
Supplement 1
Correction 1

CONTAINS CONFIDENTIAL INFORMATION

August 24, 1988

To: Members of the Executive Board

From: The Secretary

Subject: Trade Policy Issues and Developments - Industrial and Developing Countries

The following corrections have been made in SM/88/166, Supplement 1 (8/9/88):

Page 1, para. 1, line 6: for "Section I" read "Section II"

line 10: for "Section II " read "Section III"

Page 4 , last para., line 5: for "1988, twice"
read "1988, close to twice"

Page 12, line 6: for "October 1988." read "November 1988."

Page 14, table heading: for "...Investment and Manufacturing"
read "...Investment in Manufacturing"

Page 16, footnote 1, line 2: for "Colombia, Hungary"
read "Colombia, Fiji, Hungary"

Page 17, 2nd full para., lines 6 and 7: for "of arbitrarily defined target EC shares of"
read "of a specified EC share of"

Page 20, para. 1, lines 5-8: for "of developing...(NIEs)--stands out"
read "of the four Asian...China--stands out"

- over -

Page 23, 2nd full para., lines 4 and 5: for "on duty free imports"
read "on imports"

last para., line 8: for "developing countries, parties"
read "developing contracting parties"

Page 25, para. 3, lines 2 and 3: for "were raised...12 countries; for"
read "were lowered in 13 countries; for"

lines 7 and 8: for "(e.g., Argentina, Indonesia, and Thailand)"
read "(e.g., Indonesia and Thailand)"

footnote 1, line 3: for "(Argentina, Bangladesh, and Chile)"
read "(Argentina and Bangladesh)"

Page 26, lines 3 and 4: for "was often accompanied...and Chile)."
read "was sometimes accompanied...and Bangladesh)."

Page 28, 3rd full para., line 5: for "Iran"
read "the Islamic Republic of Iran"

Page 49, Table 18: Revised.

Page 52, footnote 2, line 1: for "This Annex" read "This Attachment"

Page 57, para. 2, penultimate line: for "Iran"
read "the Islamic Republic of Iran"

Page 69, para. 1, line 2: for "includes Saudi Arabia and other Gulf countries"
read "includes Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates."

Corrected pages are attached.

Att: (15)

Other Distribution:
Department Heads

## I. Introduction

This paper deals with trade issues and developments in industrial and developing countries. It provides background information to the main paper "Trade Policy Issues and Developments," SM/88/166 (8/3/88). Reference is also made to Supplements 2 and 3 of the main paper, which complement information in this paper. This paper is organized as follows. Section II describes trade policy instruments and trade-related aspects of industrial policies in industrial countries. It also describes the major trade developments in selected industrial countries, the arguments advanced for protection, and the associated costs. Section III deals with developing countries. It features trends in their exports and imports since the early 1970s, the characteristics of their trade regimes and recent changes in their trade policies. Also featured are trade measures affecting developing countries. The Attachment describes in more detail the trade and industrial policy instruments of the EC.

The growth in world trade in the first half of the 1980s slowed compared both with the previous decade and relative to output. The slowdown in the early 1980s was particularly pronounced in developing countries, whose share of world trade has tended to decline. World trade growth picked up during 1986-87 and exceeded the growth of world output, but by a narrower margin than in the 1970s. 1/

Trends in World Trade and Production 1/

(Average annual growth rates)

| | 1970-79 | 1980-85 | 1986 | 1987 |
|---|---|---|---|---|
| World output | 4.1 | 2.4 | 3.2 | 3.0 |
| Industrial countries | 3.3 | 2.2 | 2.7 | 3.1 |
| Developing countries | 5.6 | 2.6 | 4.1 | 3.1 |
| World trade volume 2/ | 6.2 | 2.4 | 4.6 | 4.9 |
| Industrial countries | 6.6 | 3.4 | 5.8 | 5.2 |
| Developing countries | 5.4 | 0.3 | 2.5 | 5.1 |

Source: IMF, World Economic Outlook, April 1988.
1/ Composites for country groups are averages of percent changes for individual countries weighted by the average U.S. dollar value of their GDP (output) and trade (trade volume) over the preceding three years.
2/ Average of export and import growth.

1/ The relative growth of world production and trade is influenced by: (a) developments in the United States, which has a larger weight in world production than in world trade, and (b) exchange rate movements between the dollar and other currencies, which affect the weights of individual countries.

A number of factors underlie developments in the early 1980s. Large macroeconomic and structural imbalances, sluggish growth, and persistent unemployment intensified protectionist pressures in industrial countries. These pressures may have contributed to the slowdown of both world trade and production. The onset of the debt problem necessitated a reduction in imports relative to production in developing countries, including some of the newly industrializing economies. The decline in oil prices led to a particularly pronounced adjustment in imports in oil-producing countries. With few exceptions, developing country policies have not been sufficiently outward-looking to achieve rapid export growth. Large exchange rate changes may also have contributed to the slowdown in world trade.

## II. Industrial Countries

### 1. Trade trends

Since 1981, the industrial countries have restored their share of world exports to almost the level prevailing before the oil shocks of the 1970s. The counterpart of this increase has been a decline in the developing countries' share to less than 20 percent of world exports. The trends in the major industrial countries diverge: Japan's share rose whereas the U.S. share declined and the EC share remained roughly stable if intra-EC trade is excluded.

Shares in World Exports of Goods 1/

(In percent)

| | 1973 | 1981 | 1986 |
|---|---|---|---|
| Industrial countries | 70.8 | 63.0 | 69.6 |
| EC (10) | (36.7) | (30.9) | (34.5) |
| Intra-EC | (19.8) | (15.8) | (19.7) |
| Japan | (6.4) | (7.8) | (9.9) |
| United States | (12.0) | (11.5) | (9.7) |
| Developing countries | 19.2 | 27.6 | 19.5 |
| Centrally planned economies | 10.0 | 9.4 | 10.8 |

Sources: GATT; UN; UNCTAD; and Fund staff estimates.

1/ Based on nominal U.S. dollar values. Comparable data for 1987 are not available from the same source, but IMF Direction of Trade data indicate a marginal decline in the industrial country share, offset by an increase in the developing country share.

These trends mainly reflect large terms of trade movements that occurred in the 1980s. Excluding trade in petroleum, agricultural products and minerals, the share of industrial countries in world exports has remained roughly constant since 1981. However, the divergent trends in the shares of Japan and the United States are also apparent for manufactured products. Although the EC share of world manufactured exports has increased, the share exported to third countries has declined.

Shares in World Exports of Manufactures 1/

(In percent)

| | 1973 | 1981 | 1986 |
|---|---|---|---|
| Industrial countries | 83.1 | 80.8 | 79.6 |
| EC (10) | (46.5) | (40.1) | (42.6) |
| Intra-EC | (22.8) | (18.9) | (23.0) |
| Japan | (10.0) | (13.3) | (14.1) |
| United States | (12.3) | (13.9) | (10.3) |
| Developing countries | 6.9 | 10.7 | 11.8 |
| Centrally planned economies | 10.0 | 8.6 | 8.6 |

Sources: GATT; UN; UNCTAD; and Fund staff estimates.

1/ Based on nominal U.S. dollar values.

## 2. Trade policies

### a. Tariffs

Successive rounds of multilateral trade negotiations have reduced MFN tariff rates in industrial countries to an average of 5-6 percent on industrial products, although tariffs on agricultural products remain considerably higher (Table 1). Average rates are lower for some products reflecting tariff reductions beyond those agreed in the Tokyo Round in some countries, as well as preferential trade agreements maintained among industrial countries and between industrial and developing countries. However, problems of tariff dispersion and escalation remain. Furthermore, not all tariffs are bound in GATT, particularly on agricultural products (Table 2); and tariff preferences granted under preferential trading arrangements are greater than preferences granted under Generalized System of Preferences (GSP) schemes (Table 3).

b. Nontariff measures

The increase in nontariff measures (NTMs) may have largely offset the liberalizing effects of tariff reductions in the postwar period. 1/ Nonfuel imports of industrial countries subject to selected NTMs are estimated by UNCTAD to have increased in the 1980s to more than one fifth of the total in 1987. The sharp increase in voluntary export restraints (VERs) between September 1987 and April 1988, as indicated by preliminary data, has probably further raised the total incidence of NTMs.

Industrial Countries: Imports Affected by
Selected Nontariff Measures 1/

(In percent of total imports)

| | 1981 | 1984 | 1987 |
|---|---|---|---|
| Non-oil imports | 18.7 | 19.9 | 22.6 |
| Of which: | | | |
| Food items | 35.3 | 38.7 | 38.2 |
| Manufactures | 18.1 | 18.3 | 21.5 |

Source: UNCTAD (1988) "Protectionism and Structural Adjustment," Geneva.

1/ Includes certain paratariff measures, import deposits and surcharges, variable levies, quantitative restrictions (including prohibitions, quotas, nonautomatic licensing, state monopolies, VERs, and bilateral restraints under the MFA), automatic licensing and price control measures. In contrast to staff estimates presented in Table 4, it also includes antidumping and countervailing actions, and import surveillance.

NTMs can take the form of border or nonborder measures. Voluntary export restraints are a common type of border measure. These are applied on a discriminatory basis outside GATT rules (Annex I) and have increased in recent years. Preliminary data indicate that 253 such arrangements existed in April 1988, close to twice as many as in September 1987. About half of them are directed at developing countries, including heavily indebted countries, and four fifths are intended to protect the EC or U.S. markets.

1/ See, for instance, the study by J. de Melo and D. Tarr, cited in Section 5.

including banking services, and investment. In agriculture, the agreement additionally prohibits export subsidies on bilateral trade, including some transportation subsidies on Canadian exports to the United States. The agreement also provides for a reciprocal opening of government procurement, reduction of technical barriers to trade, and introduction of a dispute settlement mechanism in which decisions will be binding. The two countries view various aspects of the agreement as a possible model for multilateral agreements in the Uruguay Round.

Although the impact of the U.S.-Canada Free Trade Agreement has not yet been systematically analyzed, it can be expected to provide substantial benefits to both countries as well as to the rest of the world. Earlier studies have estimated that the gains from specialization, competition, and the achievement of economies of scale could be substantial, particularly for Canada. 1/ The elimination of tariffs between the United States and Canada is unlikely to divert a significant amount of trade from third countries. The low level of tariffs in the United States reduces the competitive advantage that Canada would gain through duty free access to the U.S. market. Although U.S. exporters would gain a more significant advantage on the Canadian market that is protected by higher tariffs, the considerably smaller importance of the Canadian market in world trade reduces the scope for trade diversion. This scope is further limited by the large volume of trade between the two countries, which presently amounts to more than one third of their total trade. The effects on third countries of the simultaneous reduction in technical barriers as well as barriers to investment and trade in services are more difficult to assess because they are less transparent. Nevertheless, the real income gains in both countries resulting from the removal of trade barriers can be expected to benefit exporters in third countries.

The United States also signed a bilateral framework agreement with Mexico in February 1988. The agreement is limited to establishing a bilateral consultation mechanism governing trade and investment relations without committing either party to trade liberalization measures. The agreement with Mexico consists of a framework of principles, procedures, and an agenda under which specific sectoral and other agreements are to be concluded at a later date. It also establishes procedures for mediation of bilateral trade and investment

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1/ R.G. Harris, and D.C. Cox, "Trade, Industrial Policy, and Canadian Manufacturing," (Toronto: Ontario Economic Council, 1984) estimate the potential gains for Canada to be as high as 9 percent of GDP, including the gains resulting from previously unexploited economies of scale. This result has been challenged by other authors (see R.M. Stern, P.H. Trezise, J. Whalley, (ed.) Perspectives on a U.S.-Canadian Free Trade Agreement, (Brookings Institution, 1987). Most estimates range between 2 1/2 percent and 3 1/2 percent of GDP (see Canada Department of Finance, 1988, op. cit.). The gains for the United States would be more limited because the size of its market would increase by only 7 percent.

disputes. The agreement covers a number of sectors including steel, automobiles, textiles, and agriculture, as well as services, intellectual property rights, and trade-related investment measures. Bilateral agreements under the framework agreement reached with Mexico are expected to be negotiated after the U.S. Presidential election in November 1988.

b. Japan

Since 1985, Japan has implemented a series of market-opening measures. A three-year Action Program was launched in July 1985, guided by the principle "freedom in principle, restrictions only as exceptions." The pace of implementation of the Program was faster than planned and all measures were in place by the July 1988 deadline. Under the Program, tariffs on a broad range of industrial and agricultural products were reduced by 20 percent on average and a number of measures were enacted to improve market access. Technical standards, testing, and certification requirements were eased, and government procurement practices were modified to make competitive tendering more extensive. Quantitative restrictions on imported leather and leather footwear were abolished in April 1986. Japan submitted a proposal in the Uruguay Round to abolish all tariffs on imports of industrial products in industrial countries.

In 1988, Japan has agreed to reduce trade barriers as a result of GATT panel investigations and bilateral negotiations outside of GATT. In the agricultural sector, which has traditionally been heavily protected, Japan agreed to phase out quotas on eight out of ten products found to be inconsistent with GATT rules (Annex II). Japan is in the process of implementing necessary changes following conclusions in November 1987 of a GATT panel investigation (initiated by the EC) that the different tax rates applied to liquor of different quality and grade favored local products. Separate bilateral discussions with the United States and Australia also resulted in Japan's agreement to phase out its quotas on imports of beef and replace them by tariffs; and bilateral negotiations with the United States resulted in its agreements to phase out quotas on citrus fruits (Annex II). Bilateral discussions have also been undertaken with the EC to ease barriers arising from standards, testing and certification procedures in Japan, particularly on automobiles and pharmaceuticals.

Certain market-opening measures have also been taken as a result of bilateral discussions with the United States on sector-specific liberalization (MOSS). These discussions covered electronics, telecommunications, pharmaceuticals and medical equipment, forestry products, and auto parts. Although conducted bilaterally with the United States, the MOSS talks are perceived to have improved access on Japan's market for all exporters. However, the U.S.-Japan semiconductor agreement that was concluded in September 1986 outside the MOSS framework has given rise to concerns of discrimination against third countries (Annex III). Similar concerns have been expressed about the U.S.-Japan bilateral discussions on government procurement.

The measures that Japan has undertaken in recent years to stimulate domestic demand and improve access to its market have helped reduce protectionist pressures directed against Japan. Foreign exporters nevertheless continue to question the openness of its market. "Visible" barriers to trade in Japan, as measured by tariff rates and common types of NTMs, are among the lowest in industrial countries (Tables 1 and 4). 1/ Allegations of "invisible" barriers are often based on attitudes or traditions rather than legal or institutional barriers. Aside from standards, testing and certification requirements that have been eased to some extent under the Action Program or as a result of bilateral discussions, such barriers are perceived to include Japan's licensing system for some businesses and its distribution system. Control over Japan's distribution system by Japanese producers in some industries is perceived to be exercised through loyalty to long-established business relations and exclusive distribution arrangements. The incomplete pass-through of the yen appreciation since 1985 to import prices has been interpreted by some countries as evidence of price fixing through lack of competition in the distribution system or through administrative guidance to importers. The EC has also complained about Japan's indirect tax system which applies higher taxes on large cars. Japan is in the process of reviewing its indirect tax system. 2/

With regard to Japan's access to major industrial country markets, about two fifths of its exports to the United States and the EC are subject to some degree of restraint. These include VERs on automobiles, electronic products, machine tools, and steel (Annex III). Several of these were introduced in the early 1980s and were meant to be temporary, but have been rolled over beyond their expiration date, notwithstanding the sharp deterioration in Japan's competitiveness following the appreciation of the yen since 1985.

VERs and "administered protection," including antidumping duties, may have influenced the pattern of foreign direct investment by Japan as

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1/ Japan maintained 12 known VERs as of May 1988 affecting mainly imports of textile products from China, Korea, and Pakistan.

2/ Empirical analysis does not lend support to the view that invisible barriers in Japan have significantly restricted imports. C.F. Bergsten and W.R. Cline (The U.S.-Japan Economic Problem, IIE, 1985) find that the low share of manufactures in Japan's total imports can be largely explained by comparative advantage, given its limited natural resource endowment. Similar results were derived by G.R. Saxonhouse ("The Micro- and Macro-economics of Foreign Sales to Japan," in Trade Policy in the 1980's, W.R. Cline, IIE, 1983) who finds no evidence that "invisible" barriers are any higher in Japan than elsewhere. See also SM/86/36 (3/4/86).

exporters have sought to circumvent them by setting up operations in protected markets (Table 9). This is most evident in Japan's direct investment in the machine tool, electronics, and automobile sectors in North America and Europe, where a rising proportion of Japan's rapidly expanding direct investment abroad is directed.

Japan: Shares in Stock of Foreign Direct Investment in Manufacturing

| | All Countries | | | North America | | | Europe | | |
|---|---|---|---|---|---|---|---|---|---|
| | 1981 | 1988 | VERs 1/ | 1981 | 1988 | VERs 1/ | 1981 | 1988 | VERs 1/ |
| | | | | (In percent) | | | | | |
| Manufacturing sector | 100.0 | 100.0 | 35 | 19.3 | 40.9 | 7 | 6.7 | 9.2 | 27 |
| Of which: | | | | | | | | | |
| Non-electrical machinery | 7.1 | 9.1 | 4 | 1.7 | 4.8 | 1 | 1.0 | 1.0 | 3 |
| Electrical machinery | 12.6 | 19.9 | 8 | 5.3 | 12.4 | 1 | 1.0 | 2.0 | 7 |
| Transport equipment | 7.8 | 15.7 | 16 | 0.7 | 6.2 | 3 | 0.5 | 2.2 | 13 |
| | | | | (In US$ billion) | | | | | |
| Total | 12.6 | 36.0 | | 2.4 | 14.7 | | 0.8 | 3.3 | |

Source: Table 9.
1/ Number of VERs directed against Japan as of May 1988.

### c. European Community

The EC's large agricultural surpluses and their effects on world prices have come under increasing criticism in recent years. Reforms introduced in the EC's Common Agricultural Policy (CAP) since 1984 were motivated primarily by domestic budgetary considerations and are not perceived by some countries to have adequately addressed the underlying problems, in particular access to the EC market and subsidization of exports (Annex II). A number of trade disputes in agriculture revolve around the operations of CAP; the most recent relates to the imposition of import restrictions on apple imports (Attachment and Annex I). One third to one half of all agricultural imports in the major EC countries are covered by quotas and monitoring arrangements (Table 4).

The EC accounts for about half of the VERs applied by industrial countries. The number of VERs applied on an EC-wide basis or nationally doubled to 137 between September 1987 and April 1988. These restraints are increasingly directed against the imports of developing countries and mainly cover agriculture and food products, textiles and clothing (outside of quotas under the MFA), steel, electronics, automobiles, and footwear. Japan is particularly affected by VERs on automobiles and electronic products. Among the major EC countries, in 1986 the share of industrial imports covered by VERs and other NTMs has risen to 15.4 percent in France, 17.9 percent in Germany, and 12.8 percent in the United Kingdom (Table 4). Within these totals, restricted imports of automobiles and electronics represent 3 percent to 4 percent in each country and are directed mainly against Japan.

In 1984 the EC adopted the New Commercial Policy Instrument (NCPI) intended to counter "unfair" trade practices abroad. Since 1984, the EC has introduced important changes in its legislation on antidumping which broadened and sharpened the scope of existing rules and gave rise to trade disputes with Japan and Korea (Annex I). In addition to these countries, recent antidumping and countervailing duty actions by the EC have been directed against Brazil, Mexico, and the Eastern European countries.

The EC is in the process of implementing a broad-ranging program to reduce regulatory barriers and liberalize trade and factor movements within the Community. The program is expected to improve the EC's international competitiveness (Attachment). After the abolition of internal borders in 1992, national restrictions on imports from third countries will no longer be enforceable. Pressures exist within the EC for adoption of the most restrictive national trade regimes in some sectors on an EC-wide basis after 1992, which are resisted by members holding more liberal views. The EC noted the possibility of linking access to its integrated market to reciprocal concessions granted by trading partners on a bilateral or multilateral basis in the Uruguay Round.

### d. Canada

Canada relies mainly on border measures to protect selected industries, including textiles and clothing, footwear, automobiles, and shipbuilding. Tariffs on textiles and clothing are at least twice the average for all industrial products, and the bilateral restraint arrangements reached under the new MFA were generally more restrictive than previously. Imports of certain categories of footwear are subject to global quotas and export restraint arrangements have been negotiated with Korea and Taiwan Province of China covering categories not covered by the quota. Until recently, Canada maintained voluntary restraint arrangements with Japan and Korea limiting their exports of automobiles to the Canadian market. The VER with Japan was negotiated to prevent the diversion of Japanese exports to Canada following the U.S.-Japan VER on automobiles. Although these arrangements were not formally renewed after they expired, both Japan and Korea agreed to monitor their automobile exports to Canada in order to avoid disruption of the Canadian market. A few months after the expiration of the VER with Korea, Canada imposed provisional antidumping duties averaging 35 percent on imports of Korean automobiles. Although sector-specific assistance to industry through nonborder measures has been de-emphasized in recent years, the Government continues to provide considerable support to the shipbuilding sector through subsidies and government procurement practices.

Among the barriers to trade that Canada faces abroad, protection to agriculture by foreign producers is the most important. As a member of the Cairns Group, 1/ Canada attaches great importance to the liberalization of trade in agriculture in the Uruguay Round. Canada has also frequently been the target of antidumping and countervailing investigations initiated by the United States (Table 8) and has cited this as a barrier to trade.

5. Causes and costs of protection

Protection reflects governments' unwillingness or inability to undertake necessary structural adjustment or to withstand pressures for protection from vested interests. The arguments for protection, which have been refuted in a number of studies, 2/ ignore the costs of protection.

Traditional arguments for protection include the need to preserve or encourage mature industries (e.g., steel and shipbuilding); strategic sectors with linkages with the rest of the economy (e.g., high technology industries); sectors important for security and defense reasons (e.g., coal in Germany, agriculture in Japan); and the need to accommodate the special characteristics of sectors, such as farming. These arguments are advanced in terms of promoting the national interest although protection often promotes sectoral interests at the expense of the rest of the economy. Industrial country arguments for temporary assistance to "mature" industries to return them to competitiveness is akin to developing country arguments for protection of "infant" industries. In practice, such assistance has often proved to be self-perpetuating and to spread to other areas through the rent-seeking behavior of interest groups that want similar treatment. With the exception of production subsidies--the first-best instrument to raise sectoral output--all other forms of protection shift the cost to consumers whose interests are not legally protected. Stockpiling of products that are important for defense would obviate the need for a

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1/ The Cairns Group consists of Argentina, Australia, Brazil, Canada, Chile, Colombia, Fiji, Hungary, Indonesia, Malaysia, New Zealand, the Philippines, Thailand, and Uruguay.

2/ W.M. Corden, "Protection and Liberalization: A Review of Analytical Issues," IMF Occasional Paper No. 54, 1987.

high level of self-sufficiency produced at high cost, while income support delinked from production would accommodate the special characteristics of the farm sector.

As a considerable degree of adjustment of mature industries has occurred in the 1980s in industrial countries, 1/ other arguments have come to the fore. Protection is frequently motivated by the perceived lack of a "level playing field," (i.e., competition without government assistance and subject to the same rules), particularly against centrally planned economies (China and Eastern Europe); Japan's distribution system and other so-called invisible barriers; and the newly industrializing economies (NIEs) because of the lack of reciprocity and perceived undervaluation of exchange rates.

Persistent large external imbalances have given rise to the use of trade measures to counter macroeconomic disequilibria. Some market-opening discussions have taken the form of attempts to achieve a better balance in bilateral/sectoral trade. Additionally, the EC automobile industry has argued that access of Japan's automobile exports to the integrated EC market should depend on the achievement of a specified EC share of Japan's market. Attempts to balance sectoral/bilateral trade or, more generally, the use of trade measures to improve the current account ignore its fundamental determinants. Protection will not improve the current account unless it affects the savings-investment balance of the private or public sector. This would be the case for revenue-generating forms of protection such as tariffs or import licenses that are auctioned. The improved fiscal position might then improve the current account. However, the prevalent forms of protection in industrial countries either transfer the windfall gains to foreign exporters (VERs and minimum price undertakings) or entail a budgetary cost (subsidies).

Certain types of protection insulate the protected sector from exchange rate movements, thereby slowing the macroeconomic adjustment process. This is the case with trade "managed" through VERs and quotas on a number of products. Examples include Japanese import quotas on agricultural products, bilateral import restraints by the EC and the United States on automobiles, steel, textiles, and machine tools, by the EC and Canada on footwear and clothing, and by several industrial countries on agricultural products. A similar effect arises from subsidies and import duties that are designed to compensate for the difference between domestic and world prices. Examples include variable import levies and export subsidies under the EC's CAP, and variable subsidies to the German coal industry. Indirectly, the same considerations apply to the shipbuilding sector in the EC, where subsidies depend, to some extent, on the difference between domestic

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1/ See Annex III. While significant reductions in installed capacity have occurred in a number of industries, such as steel and shipbuilding, capacity utilization in OECD countries remains low.

costs and those of the most competitive world supplier. Along the same lines, the "dollar clause" proposed by the EC in the aircraft financing agreement under negotiation with the United States would partly insulate the Airbus consortium from exchange rate movements (Annex III). Some modifications being proposed to the Producer Subsidy Equivalent (PSE) concept, 1/ which might be used in multilateral negotiations on agriculture, are intended to neutralize the effects of exchange rate changes, at least over certain periods. Moreover, the use of countervailing and antidumping duties as a safeguard measure in cases where exchange rate appreciation affects the outcome of the "injury" test has a similar effect. Sectors that are insulated to some degree account for 24.6 percent of agricultural imports and 12.5 percent of industrial imports of the G-5 countries. 2/ These forms of protection are viewed partly as a response to exchange rate instability. Greater exchange rate stability among the major currencies is therefore viewed as promoting more open markets. However, by insulating these sectors from exchange rate movements, protection shifts the burden of adjustment to other sectors and may contribute to larger exchange rate fluctuations than might otherwise be the case.

Within the context of the Uruguay Round, industrial countries argue that protection cannot be reduced unless all countries agreed to liberalize together. This applies particularly to trade in agriculture but has been advanced in connection with all trade, including steel and services. Indicative of this reasoning are the discussions pursued by the EC to obtain reciprocal concessions from trading partners in exchange for access to its integrated internal market (Attachment).

The above arguments ignore the costs of protection and the benefits of unilateral liberalization. The costs of protection have been extensively analyzed in the economic literature. 3/ It is widely recognized that protection imposes costs both on the country initiating it and on its trading partners. Any measure that restricts imports also restricts exports by shifting resources to the import-competing sector. Similarly, subsidies and other nonborder measures targeted at specific industries necessarily divert resources from other industries, thereby "taxing" the rest of the economy. Protection can also involve direct budgetary costs or indirect costs through forgone tariff revenue. Protection entails costs due to forgone specialization

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1/ The PSE concept is defined in Annex II.

2/ Based on detailed information underlying Table 4 on selected NTMs; includes VERs, quotas, import licensing, and variable levies but excludes tariffs with quotas and pricing measures, which are not automatically adjusted to offset exchange rate movements. This is a conservative estimate of the importance of insulated sectors, insofar as it excludes (a) variable subsidies, e.g., to shipbuilding, coal, and aircraft, and (b) pricing measures, including ADs and CVDs, that depend to some extent on the competitiveness of the domestic industry.

3/ See W.M. Corden (1987) op. cit., for a survey.

according to comparative advantage, as well as losses in terms of scale economies, product differentiation and R and D efficiency. Additional costs are incurred because scarce resources are directed at rent-seeking activities and enforcement of restrictions imposes administrative costs. By releasing resources for efficient industries, unilateral liberalization can increase potential growth and ease the external constraint. 1/

Protection provided through NTMs tends to be highly selective, favoring a few domestic industries. NTMs compound relative price distortions arising from the dispersion in tariff rates (tariff peaks). A study of the dispersion of protection in German industry found that the coefficient of variation 2/ of nominal protection increases from 0.4 for tariff protection to 1.0 for total protection including NTMs (Table 10). The coefficient of variation of total effective protection, which includes the effects of the escalation of tariff and nontariff protection on products at higher stages of processing, is calculated at 2.0.

The cost of VERs is high for the markets they are intended to protect because of "quota rents" (normally captured by the exporting country) and distortion costs. The cost of U.S. VERs on imports of automobiles, steel, and textiles has been estimated at US$21 billion, of which the quota rent amounts to US$14 billion and the distortion costs of the quotas to US$7 billion. 3/ The cost of "preserving" a job is estimated at eight times the average annual wage in the textile sector and three times in the steel sector. The economy-wide tariff equivalent of the quotas on these three sectors is estimated at 25 percent, bringing protection to its level of the early postwar years. Similar studies of the costs of the MFA have estimated the quota rent transferred to the Asian NIEs by OECD countries at US$2 billion. 4/ The costs of VERs on automobiles maintained by the EC and Canada have similarly been found to be very high (Annex III).

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1/ See Annex II for a discussion of the costs and benefits of liberalization in agriculture.

2/ The coefficient of variation is the standard deviation of protection across sectors divided by the average protection for all sectors.

3/ These estimates, based on a general equilibrium model of the U.S. economy, vary by US$2 billion under alternative assumptions on demand and supply elasticities of the protected products and on the terms-of-trade effects of a removal in protection. See J. de Melo, and D. Tarr "Welfare Costs of U.S. Quotas on Textiles, Steel and Autos," World Bank Working Paper (forthcoming) (1988).

4/ OECD, Costs and Benefits of Protection (1986).

## III. Developing Countries

### 1. Trade trends

Since 1981, major changes have occurred in the pattern of trade of developing countries (Tables 11 and 12). Their share of world exports has declined, reflecting the substantial decline in the value of oil exports that offset the increase in their share of world non-oil exports including world manufactured exports. The rapid growth of exports of the four Asian newly industrializing economies (NIEs)--Hong Kong, Korea, Singapore, Taiwan Province of China--stands out in this trend. An increasing proportion of developing country non-oil exports was directed toward industrial countries, reflecting the continued importance of industrial countries as a market for the products of developing countries.

The ratio of exports to GDP rose during 1981-85 for about half of the 48 developing countries surveyed, comparable to the increase in the 1973-81 period (Table 12). Declines since 1981 were largest among the oil-exporting countries, while increases outnumbered falls in African and Western Hemisphere countries, reflecting their response to the debt crisis.

Among the developing countries, the combined share of world exports of the four Asian NIEs has risen steadily from 3 percent in 1973 to 4.3 percent in 1981 and to over 6 percent in 1986. 1/ During this period the exports of the four Asian NIEs grew at an annual average rate of 17 percent, and at a rate of 10 percent a year since 1981. Exports of other geographical groupings of developing countries declined during 1981-86, at annual average rates of 8 percent in Africa, 2 percent in other Asian developing countries, 5 percent in Latin America, and 17 percent in the Middle East, compared with a growth rate of world exports of about 2 percent.

In contrast to the developments in total exports, the developing countries' exports of manufactures grew in excess of the world rate during 1973-86. As a result, the share of developing countries in world exports of manufactures rose from 7 percent in 1973 to 12 percent in 1986 (Table 11). Most of this increase was attributable to the four Asian NIEs, whose share rose from 4 percent in 1973 to 8 percent in 1986; since 1981 the share of the other developing countries has fallen

1/ See Table 17 in the companion paper on "The Industrial Policies of Industrial Countries and their Effects on Developing Countries," SM/88/167 (8/4/88).

from 4.5 percent to 3.9 percent in 1986. 1/ Between 1973 and 1985, slightly less than one half of the increase in developing countries' exports of manufactures came from engineering products (including machinery, transport equipment, office equipment, and electrical goods), into which the four Asian NIEs in particular have diversified (Table 13). Many developing countries' exports of manufactures continued to be concentrated in traditional sectors, like textiles and clothing. These sectors, together with other consumer goods, accounted for a further one third of incremental exports of manufactures. Overall, developing countries captured about 14 percent of the increase in world exports of manufactures, with increases above this average in clothing, textiles, other consumer goods, and other semimanufactures.

The decline in export earnings and the financial constraints arising from the debt crisis have led to a decline in the share of developing country imports in world imports between 1981 and 1986 (Table 14). About three fourths of the countries included in Table 12 also experienced a decline in the ratio of imports to GDP during the period 1981-85. During 1973-81 this ratio had risen in about 70 percent of the cases.

Developing countries' imports, after growing at an annual rate of 22 percent during 1973-81, declined by 4 percent a year in the period 1981 to 1986. During the whole period their imports increased at a rate of about 11 percent a year, with imports of manufactures growing at a slightly higher rate than those of primary products. Since 1981, the imports of the African and Middle Eastern developing countries have declined at roughly the same annual rate of between 7 percent and 8 percent, while those of the Latin American countries, after falling by one third during 1981-85, recovered by almost 5 percent in 1986. The imports of the Asian developing countries fell marginally in 1982 but have since grown at a yearly rate of 2.5 percent.

Industrial countries remained by far the major suppliers of the developing countries, accounting for 64 percent of their imports in 1986. However, the importance of developing countries as markets for industrial countries has declined; in 1986 some 18 percent of industrial countries' exports went to the developing countries compared with 26 percent in 1981.

2. Trade policies

As indicated in previous Fund staff papers, the diverse historical and economic backgrounds and recent economic performance of developing

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1/ Aggregate data conceal some important country differences. Since 1979 the average growth rate in a number of other developing countries, including Brazil, China, Indonesia, Mexico, Saudi Arabia, and Thailand, has exceeded the world growth rate.

economies complicate an overall assessment of their trade policies. 1/ Some developing economies (e.g., Hong Kong, Malaysia, Singapore, and many African countries) inherited relatively liberal trade regimes at independence, while others (e.g., Argentina, Brazil, and many other Latin American countries) have historically maintained highly protective trade regimes. Their growth and development strategies have also varied: some countries have adopted inward-looking growth strategies, while other countries have adopted more outward-oriented growth strategies, under which they have continued to liberalize their trade regimes.

An assessment of trade policies in developing countries is also complicated by other factors. First, countries undertaking trade liberalization programs usually as a first step replace quantitative restrictions with tariffs; this normally involves an initial increase in tariffs followed by a subsequent reduction. Second, customs duties have historically been an important source of government revenue in the early stages of economic developement because they are easier to collect than domestic income or consumption taxes when tax administration is weak and tax handles are limited; smaller economies and Asian and African countries depend more heavily on tariffs as a source of revenue than other developing countries (Table 15). Finally, macroeconomic imbalances may result in an increase in trade protection as an alternative to remedial policies to correct the savings-investment balance; in such a situation, an increase in import duties may be a means to reduce the fiscal deficit. 2/ 3/

a. Tariffs

Statutory tariffs are generally higher in developing countries than in industrial countries, typically ranging from zero to very high maximum rates. A recent study of 50 developing countries, which account for about 15 percent of world trade (average of exports and imports), provides results based on 1985 data. 4/ It found that the unweighted average rate of tariffs for all products was 26 percent, or 34 percent if other import charges were included. 5/ The corresponding weighted averages (based on country imports) were 24 percent and 30 percent, respectively. The latter figures can be compared with less than

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1/ S.J. Anjaria, N. Kirmani, and A.B. Petersen, "Trade Policy Issues and Developments," IMF Occasional Paper 38, Washington, D.C., July 1985.

2/ Over the period 1980-84, over one third of Fund-supported adjustment programs relied on general or selected increases in customs duties and import surcharges.

3/ For a fuller elaboration of these points, see Z. Farhadian-Lorie, and M. Katz, "Fiscal Dimensions of Trade Policy," WP/88/43, May 1988.

4/ R. Erzan, H. Kuwahara, S. Marchese, and R. Vossenaar, "The Profile of Protection in Developing Countries," UNCTAD, Discussion Paper No 21.

5/ Other import charges consist of customs surcharge and surtax, stamp taxes and other fiscal charges, and taxes on foreign exchange.

5 percent on average for OECD countries. While variations existed among regional groupings, the study reported an inverse relationship between per capita income and tariff levels (Table 16). This inverse relationship is consistent with other studies which indicate that customs revenues become less important as a source of government revenues as the income level increases. 1/ It is also consistent with other studies which indicate the superiority of outward-oriented over inward-oriented trade strategies in raising income levels.

The structure of tariffs in developing countries is broadly similar to that in industrial countries. Products such as tobacco, beverages, textiles, clothing, manufactures, and certain foodstuffs are subject to above average duties, while fuels, chemicals, metal and metal products, minerals and mineral products are subject to below average tariffs.

Statutory rates tend to be substantially higher than average rates of duties collected (Table 15). The difference between statutory and average levels reflects a number of factors: (i) "duty drawback" schemes which some countries (e.g., Brazil and Colombia) allow on imports of raw materials and intermediate inputs; (ii) similar privileges which some countries (e.g., Brazil and Mexico) offer to attract foreign investment or to promote investments to specific projects or regions; (iii) preferential tariff reductions which a number of developing countries grant each other under preferential trade arrangements; 2/ and (iv) temporary tariff reductions on a continuous basis on a wide range of products (e.g., Brazil).

Under GATT, a contracting party provides assurance of market access by "binding" its tariffs. This places limits on its legal ability to raise tariffs without compensating its trading partners. The major industrial countries have bound between 88 percent and 98 percent of their tariffs. For the developing countries the proportions are much lower. Only Mexico and Chile have bound 100 percent of their tariff schedules at maximum rates of 50 percent and 35 percent, respectively. For 18 other developing contracting parties for which information is available, the proportion ranges from zero percent to 39 percent with most falling in the 20-25 percent range.

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1/ Z. Farhadian-Lorie and M. Katz, op. cit., and references therein.

2/ Preferential trading arrangements among developing countries include the Association of South East Asian Nations (ASEAN); agreements among members of the Economic and Social Commission for Asia and the Pacific (ESCAP); Latin American Integration Association (LAIA); Central American Common Market (CACM); Caribbean Community (CARICOM); West African Economic Community (CEAO); Economic Community of the Great Lake Countries (CEPGL); Economic Community of West African States (ECOWAS); Mano River Union (MRU); Customs and Economic Union of Central Africa (UDEAC); and Cooperation Council of the Arab States of the Gulf (GCC).

The combination of high statutory tariffs with substantially lower actual average tariffs and a low level of tariff bindings has implications for the certainty of trading partners' access to developing country markets. In these circumstances average tariffs may be increased substantially--through changes in duty remissions and other schemes--rather than amendments to the tariff schedule. Moreover, where tariffs are not bound, statutory tariffs can be increased without legal implications in GATT.

b. Nontariff measures 1/

Developing countries frequently use NTMs as a major form of protection. A study for 50 developing countries found that 40 percent of all tariff lines (weighted by economic size) were subject to some form of NTM. 2/ Excluding NTMs which were applied to all imports, the ratio was 27 percent. Import licensing was found to be the most common form of NTM although foreign exchange restrictions were the most prevalent in Latin America and the second most frequent in sub-Saharan Africa. As in the case of tariffs, an inverse relationship was found between per capita income and the frequency of use of NTMs (Table 17).

A significant feature of NTMs of developing countries is that not only are they widespread but they are also stacked, i.e., a given product is subject to more than one restriction. 3/ While foodstuffs are the most affected sector, it is notable that all categories have higher frequencies of NTMs than most industrial countries. In particular, textiles, clothing and footwear, and iron and steel all had high frequencies of NTMs (and higher tariffs) despite the apparent comparative advantage of developing countries in these products. In contrast to industrial countries where there is increasing resort to discriminatory measures, NTMs are normally applied on a nondiscriminatory basis in developing countries.

The GATT provisions on balance of payments restrictions are the most frequently invoked justification for restrictions by developing countries that are contracting parties to GATT. Some 85 percent of quantitative restrictions that have been notified to GATT by 24 developing countries have been justified for balance of payments reasons.

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1/ Nontariff measures include import licensing, quotas, and prohibitions; foreign exchange authorizations; other financial measures; minimum import prices; and inspections and standards.

2/ R. Erzan, H. Kuwahara, S. Marchese, and R. Vossenaar, op. cit.

3/ O. Havrylyshyn, Barriers to Trade Among Developing Countries, UNCTAD/UNDP, March 1988, found that this duplication mainly occurred in sub-Saharan Africa and across all regions in the food category.

c. Recent developments

A trend toward more liberal trade policies is evident in a number of developing countries. Such reform is part of wider structural reform efforts taking place, and indicates a growing awareness on the part of these countries of the benefits of outward-oriented policies. In some Latin American countries, notably Bolivia and Mexico, trade liberalization has additionally occurred in the context of anti-inflation programs. Some countries have been able to roll back restrictive measures introduced at the outset of the debt crisis while the strong external positions of Korea and Taiwan Province of China have permitted these countries to continue with the liberalization of their trade regimes.

Despite these positive developments, for many countries trade liberalization continues at a slow pace, because of inward-looking development policies, or has taken a reverse course partly due to financial difficulties arising from a high debt service burden or failure to implement domestic policies necessary to improve the trade balance.

Information collected on 31 developing countries covering the period 1985-88 indicates that tariffs were lowered in 13 countries; for the rest, changes were mixed or no information was available (Table 18). In a number of these countries trade reform involving initially the substitution of quantitative restrictions with tariffs, and subsequently a reduction in tariffs, was underway. 1/ In some countries (e.g., Indonesia and Thailand) temporary surcharges or temporary increases in tariffs were used as supplementary measures to counter surges in imports; some of these countries continued to rely on quantitative restrictions as the basic mechanism for protection and defense against chronic balance of payments problems. In other countries (e.g., Brazil) domestic shortages were countered through temporary reductions in tariffs or temporary surcharges were eliminated when emergency situations no longer prevailed. Trade liberalization measures have also been taken to ease domestic inflationary pressures (e.g., Mexico), and tariff reductions on certain products have been used to impose the discipline of world prices on domestic producers.

With regard to NTMs, 18 countries moved in the direction of liberalization while 6 countries moved in the opposite direction. For some countries (e.g., Egypt, Korea, Mexico, Morocco, and Taiwan Province of China), the liberalization of quantitative restrictions has been accompanied by a general reduction in tariffs and import-related

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1/ This was the case for some countries which reduced tariffs (Egypt, Mexico, Taiwan Province of China, and Uruguay), for some which increased tariffs (Argentina and Bangladesh), and others where the direction of tariff changes was mixed (Nigeria and Zaire).

taxes. 1/ However, for other liberalizing countries, including those which have been in the process of substituting nontariff barriers with tariffs, the liberalization was sometimes accompanied by higher tariffs (e.g., Argentina and Bangladesh).

In April 1988, a group of developing countries agreed to set up their own trade preference system, the Global System of Trade Preferences (GSTP), at a ministerial meeting in Belgrade. The agreement was adopted by 48 countries, including Argentina, Brazil, Egypt, India, Mexico, Nigeria, and Pakistan. The arrangement explicitly excludes large industrial nations, and aims to promote trade between developing countries. The initial impact of the system is not expected to be large; UNCTAD estimates that the GSTP will cover less than US$10 billion of imports.

d. Trade policies of NIEs

Some common features of the four Asian NIEs are their outward-oriented growth strategies, their relatively poor natural resource bases, and their recent high annual average growth rates. However, beyond these, there are a great many differences among them. One important difference is that Hong Kong and Singapore are basically free trade ports and have few or no trade or exchange restrictions. The situations of Korea and Taiwan Province of China are more complex and developments need to be reviewed individually.

Korea has made significant progress in liberalizing its import system since 1980, when over 30 percent of tariff code items were listed as restricted imports. By 1983, the share of restricted items had been reduced to 19 percent and, starting in 1984, a major new liberalization five-year program was launched. As a result, the ratio of restricted items was reduced to less than 5 percent by April 1, 1988. 2/ Agriculture remains the most heavily protected sector, accounting for over three fourths of the remaining restrictions. To safeguard against import surges, newly liberalized imports may be placed on an import surveillance list, or subjected to adjustment tariffs; however, the use of both procedures has been limited. 3/ The surveillance list is scheduled to be eliminated by the end of 1988.

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1/ In the case of Egypt, the lifting of import licensing requirements has been accompanied by an increase in exchange restrictions and by the introduction of a list of 210 banned imports.

2/ In sectoral terms, liberalization was more significant on electrical and machinery appliances, electronics, machinery, and textiles.

3/ Of the 6,945 items liberalized through June 1986, only 106 were placed on the surveillance list, and by April 1, 1988 they were reduced to 25.

The Tariff Act was amended with effect from January 1, 1984. Revisions in the Act aimed to improve competitiveness of Korean industry and provided for a lowering of tariff rates and a narrowing of their dispersion. As a result, the average unweighted tariff rate was reduced from 23.7 percent in 1983 to 18.1 percent in 1988.

The above measures may have been partly offset by the operation of 39 special laws for both agricultural and nonagricultural products which permit government agencies to determine the source and type of certain imports. These laws have been reviewed and steps are being taken to streamline their application and reduce the extent to which they serve as unnecessary barriers.

In the case of Taiwan Province of China, high tariffs have been the main barrier to imports. Since the early 1980s tariffs have been cut and the proportion of imports subject to import licensing has been reduced. The average nominal tariff rate fell to 23 percent in 1986. In 1987 further tariff cuts were implemented affecting 40 percent of items. At end-1986, about 20 percent of Taiwan Province of China's imports were subject to nonautomatic licenses.

e. Countertrade 1/

Since the late 1970s countertrade has been used extensively by developing countries. Countertrade has been utilized as an export promotion tool, and as a way to overcome shortages in foreign exchange and protectionist barriers in industrial countries. 2/ Some developing countries may also have used it to counter the effects of overvalued exchange rates, in which case it functions as an export subsidy. Latin American and African countries have also explored countertrade as a mechanism for intraregional economic cooperation.

While neither the Fund nor the GATT has jurisdiction over countertrade unless restrictions are involved (e.g., official action affecting the private sector), the Fund is generally concerned with the increased use of countertrade because it undermines the multilateral character of the trade and payments system and imposes additional costs on the participants. One aspect of this is that the complexity of

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1/ The topic of countertrade was reviewed by the Executive Board in 1982 on the basis of the staff paper "Review of Bilateral Payments Agreements, 1976-81," SM/82/169 (8/17/82). Developments have since been reported in successive editions of the Annual Report on Exchange Arrangements and Exchange Restrictions. For details on the various forms of countertrade, see also K.M. Huh, "Countertrade: Trade without Cash?" Finance and Development, December 1983, and Group of Thirty Countertrade in the World Economy, New York, 1985.

2/ For instance, countertrade can be used to gain a larger share of a global quota but it cannot gain greater access to markets protected by VERs.

matching up parties for specific commodities generally increases transaction costs. In addition, countertrade to bypass price distortions in the economy, including the exchange rate, is not an efficient means to correct distortions. Countertrade practices may entail many of the restrictive and discriminatory practices traditionally associated with bilateralism.

The extent of countertrade is difficult to gauge because trade data are not differentiated according to the source of financing, and because countertrade often involves military purchases for which data are not always available. 1/ The OECD has estimated that a maximum of some US$80 billion or 5 percent of world trade occurred through countertrade arrangements in 1983. This estimate excludes trade under bilateral payments arrangements among Eastern European countries and among some developing countries. Including these, the total would rise to at least 9 percent of world trade. The share of trade that occurs under documented countertrade agreements is highest between East European countries and both developing and industrial countries, and among developing countries.

Estimates made by various bodies indicate a sharp growth of countertrade between 1980 and 1984, followed by stagnation and a decline in 1987. In 1987, the number of countertrade agreements signed decreased by about 45 percent. The trend toward more open export credit and cover policies since 1985 may have reduced countertrade transaction associated with the absence of trade financing. The high transaction costs of countertrade agreements may also have contributed to this decline.

Countertrade has normally involved raw materials, particularly oil but also cereals, textiles and clothing. The use of oil in countertrade continues, albeit at a reduced rate, despite a 1985 decision by OPEC countries to phase out their use of countertrade agreements. Among OPEC countries, Indonesia, the Islamic Republic of Iran, Iraq, Libya, and Saudi Arabia have been involved in countertrade. Indonesia, which has legislation on countertrade, signed about 75 percent fewer agreements in 1987 than in 1983, its peak year for such agreements.

Other Asian countries using countertrade to varying degrees have been China, India, Korea, Malaysia, Pakistan, the Philippines, Singapore, Taiwan Province of China, and Thailand. Much of their countertrade is with other developing countries, although Korea, Malaysia, Taiwan Province of China, and Thailand have also used it to increase their trade with centrally planned economies, and China has used it in trade with Western economies.

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1/ Countertrade among industrial countries often occurs in connection with trade offsets in sales of aircraft or military equipment. Australia and New Zealand have adopted official guidelines with respect to countertrade.

Table 18. Developing Countries: Summary of Trade Measures, October 1985-April 1988

| | Tariffs | | | NTMs | | | |
|---|---|---|---|---|---|---|---|
| | Up | Down | Mixed | Tightened | Liberalized | Mixed | Memo 1/ |
| Argentina | | | X | | | X | |
| Bangladesh | | | X | | X | | |
| Brazil | | X | | X | | | |
| Chile | | X | | | | X | |
| China | | | X | X | | | |
| Colombia | | | | | X | | |
| Côte d'Ivoire | X | | | | | | |
| Egypt | | X | | | X | | C |
| Gabon | | | | X | | | |
| Ghana | | | | | X | | |
| India | | | X | | X | | |
| Indonesia | | | X | | X | | S, C |
| Kenya | | | X | | | | |
| Korea | | X | | | X | | |
| Malaysia | | X | | | | | |
| Mexico | | X | | | | X | S, C |
| Morocco | | X | | | X | | |
| Nigeria | | | X | | X | | C |
| Pakistan | | | X | | X | | |
| Peru | | X | | X | | | |
| Philippines | | | X | | X | | S |
| Sri Lanka | | | | | X | | |
| Taiwan Prov. of China | | X | | | X | | |
| Thailand | | X | | | X | | |
| Singapore | | X | | | | | |
| Tunisia | | X | | X | | | |
| Turkey | | | X | | X | | |
| Uruguay | | X | | | | | C |
| Yugoslavia | | | | X | | | |
| Zaire | | | X | | | | C |
| Zambia | | | | | X | | |
| Total | 1 | 13 | 11 | 6 | 18 | | ... |

Source: GATT, Developments in the Trading System, various issues.

1/ C = Comprehensive Tariff reform.
S = Substitution of quantitative restrictions with tariffs.

Table 19. OECD Preference-Giving Countries' Imports from GSP Beneficiary Countries, 1972-86 1/

(In billions of U.S. dollars)

| | Total Imports | Total Dutiable | Covered by GSP | Accorded GSP Treatment |
|---|---|---|---|---|
| 1972 | 35.0 | 15.9 | 4.3 | 1.0 |
| 1973 | 43.2 | 24.0 | 6.6 | 2.2 |
| 1974 | 102.1 | 44.6 | 12.4 | 4.2 |
| 1975 | 100.7 | 43.9 | 12.0 | 4.5 |
| 1976 | 146.4 | 74.0 | 23.7 | 10.2 |
| 1977 | 160.7 | 82.4 | 26.8 | 12.4 |
| 1978 | 167.4 | 89.5 | 33.5 | 15.0 |
| 1979 | 224.5 | 124.0 | 42.4 | 20.3 |
| 1980 | 308.8 | 178.7 | 55.4 | 25.4 |
| 1981 | 314.4 | 179.4 | 54.2 | 26.5 |
| 1982 | 295.0 | 179.1 | 54.7 | 26.6 |
| 1983 | 275.4 | 177.5 | 56.7 | 27.9 |
| 1984 | 281.4 | 187.7 | 69.6 | 34.0 |
| 1985 | 284.1 | 189.1 | 73.2 | 35.6 |
| 1986 2/ | 269.0 | 179.0 | 81.6 | 35.9 |

Source: OECD, "OECD Imports from GSP Beneficiaries in 1986," March 30, 1988 (TC/WP(88)24).

1/ The figures in this table represent totals for those OECD preference-giving countries which were operating GSP schemes in each year. The following countries are included beginning in the years indicated: 1972: EEC, Austria, Finland, Japan, Norway, Sweden, Switzerland, United Kingdom; 1975: Australia, Canada; 1976: New Zealand, United States.

2/ Preliminary.

# The European Community: Aims and Instruments of Trade and Industrial Policies

## I. Introduction and Summary

The European Communities (EC) were established by the Treaty of Paris (1951) and the Treaties of Rome (1957). 1/ The original six EC members 2/ were later joined by the United Kingdom, Ireland, and Denmark in 1973, Greece in 1981, and Spain and Portugal in 1986. Excluding intra-area trade, the EC now accounts for almost one fifth of world exports and nearly as much of world imports. Its weight in world trade is thus somewhat less than that of the United States and Japan taken together (Table 20).

The institutional structure of the Community, organized along the lines of a national administration, consists of the EC Commission, the Council of Ministers, the European Parliament, and the European Court of Justice, which constitute the administrative, legislative, and judicial branches of the EC. The Commission implements Community policy, enforces EC treaties, and proposes legislation to the Council. The Council, which is primarily a forum for national interests, is the final decision-making body. The Presidency of the Council of Ministers rotates among EC member countries on a semiannual basis. The European Parliament, elected by popular vote, has advisory powers under which it delivers to the Council nonbinding opinions on Commission proposals and has supervisory powers over the Commission. The Parliament is also responsible for final approval of the EC budget. The budget finances the EC's Common Agricultural Policy as well as EC regional and social programs using revenues from the common external tariff and part of value added taxes collected by Community members. More recently the Parliament has acquired the power to reject or amend Council decisions pertaining to the unification of the EC market under the Single European Act. The Court of Justice interprets and applies EC treaties and enforces Community law. Each member state of the EC and also the European Economic Community (EEC) as a separate entity are members of GATT. Within GATT they are represented by the Commission.

The EEC Treaty which took effect on January 1, 1958 provided for the elimination of trade barriers within the Community and the establishment of a common external tariff against the rest of the world. Besides establishing a customs union, the treaty provided for a common market permitting the free movement of capital and labor within the

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1/ The EC comprises three Communities: the European Coal and Steel Community (ECSC) governed by the Treaty of Paris, the European Economic Community (EEC), and the European Atomic Energy Community (EURATOM) governed by the Treaties of Rome. The institutions of the three communities were merged in 1965 and are henceforth referred to as the European Community (EC).

2/ Belgium, France, Germany, Italy, Luxembourg, and the Netherlands.

Community. Customs duties and quantitative restrictions on intra-area trade were progressively reduced and were eliminated in July 1968, one and a half years ahead of schedule. This contributed to an increase in intra-area trade from 38 percent of total EC trade in 1960 to 58 percent in 1987, most of which occurred between 1960 and 1970 (Table 21). However, progress in liberalizing factor movements within the Community has been somewhat slower.

In addition to establishing a common market, the EEC Treaty provided for a common agricultural policy (CAP). 1/ This was viewed as an essential step toward freeing intra-area trade in agriculture given the diversity of existing support schemes in the six original EC member countries and the perceived need to protect the agricultural sector. The CAP aimed to maintain a fair standard of living for farmers, reasonable prices for consumers, and to stabilize markets. These objectives have increasingly proved conflicting. Agricultural support has been provided at a high cost to consumers, taxpayers, and non-agricultural producers in the EC, and together with policies of other major industrial countries, has had adverse effects on efficient agricultural exporters (Section II.2).

With the exception of the common external tariff and CAP, the Community's commercial policy relative to third countries was not clearly defined in the EEC Treaty. Article 113 governing EC commercial policy merely enumerated examples of commercial policy measures without spelling out the regime governing the exchange of goods and services and the movement of labor and capital between the EC and third countries. Common rules for all EC countries have not so far been established because of divergent views among member states on the desirable level of restrictiveness of the Community's external regime. Thus, EC countries generally maintain national quantitative restrictions on imports from third countries enforced through national import licensing systems, standards, and certification procedures. The Community nevertheless possesses a number of common commercial policy instruments in addition to the common external tariff. These include EC-wide quantitative restrictions and legislation dealing with unfair trade practices abroad.

Industrial policies in the EC are regulated through the EC Treaties' provisions on competition. 2/ These include the EEC Treaty provisions on state aids and the ECSC Treaty provisions on the coal and steel sectors, whose purpose is to limit state aids and business practices that restrict competition within the Community. To the extent that state aids are permitted these may substitute for tariff protection within the Community; they also may substitute for border measures in providing protection against non-EC members. The Commission has

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1/ The effects of the CAP were discussed in "The Common Agricultural Policy of the European Community--Principles and Consequences," DM/88/1. See also "Agricultural Trade Policies," Annex II.

2/ This Attachment covers trade-related aspects of Community-wide regulations on industrial policies and their implementation.

The quantitative import restrictions maintained by the EC fall under three broad categories: EC-wide restrictions, national restrictions recognized by the EC, and industry-to-industry export restraint arrangements which do not involve member governments and are not recognized by the EC.

EC-wide restrictions include those concluded under the MFA as well as a number of VERs. Import quotas negotiated under the MFA by the EC Commission are split into subquotas applying to individual member countries. As of May 1988, the EC had concluded 20 bilateral agreements on textiles and clothing under MFA IV. VERs are maintained on imports of steel, textiles, clothing, agricultural and food products, machine tools, automobiles, and electronic products. With one exception (footwear), these are government-to-government arrangements. Imports of steel are governed by bilateral quotas or minimum prices which, if not observed, can lead to dumping actions against foreign suppliers; these restrictions apply to a wide range of exporting countries including Japan and other industrial countries, newly industrializing economies and state trading countries. Outside of the MFA, the EC has 18 additional bilateral agreements on textiles and clothing; these include bilateral agreements with Turkey under the safeguard provisions of Turkey's Association Agreement with the EC and agreements with Egypt, Morocco, Tunisia, Yugoslavia, Bulgaria, the Islamic Republic of Iran, and a number of Latin American countries.

National restrictions include VERs and other gray-area measures as well as "residual" restrictions. VERs apply mainly on imports of automobiles and transport equipment, electronics, and footwear, and take the form either of government-to-government or industry-to-industry agreements. Most of these restrictions protect the markets of France, Italy, and the United Kingdom. Imports of automobiles from Japan are restricted in France, Italy, Portugal, Spain, and the United Kingdom. 1/

The so-called residual restrictions remained in place after most quantitative restrictions were lifted in the first 15 postwar years. In 1955, the GATT adopted a decision known as the "hard core waiver," which permitted certain restrictions to be maintained for a specified time period. The residual restrictions remaining in place, after the waivers issued under the GATT's 1955 decision lapsed, are incompatible with the provisions of GATT Article XI, which calls for the general elimination of

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1/ The restrictions by France and the United Kingdom are industry-to-industry agreements and are not approved by the Commission. The restriction by Italy is approved by the Commission. It originated from a reciprocal self restraint arrangement concluded in the 1950s and was initially intended to protect the Japanese market against imports of Italian cars. The restrictions limit imports to 3,425 units (Italy), 3 percent of estimated domestic demand (France), and 11 percent of estimated U.K. sales (United Kingdom).

quantitative restrictions. 1/ The EC has offered to abolish some of these residual restrictions, which constitute only a small proportion of national restrictions maintained by EC members, as part of its rollback commitment in the Uruguay Round.

4. Enforcement of quantitative restrictions

EC-wide restrictions are enforced through import licensing procedures which are applied at the Community level (see below). National restrictions on imports of goods from third countries that are in free circulation within the Community are enforced through Article 115 of the EEC Treaty or, in cases when restrictions are not officially recognized by the EC, through national import licensing or standards and certification procedures.

Article 115 empowers the Commission to authorize a member country to apply protective measures against imports from third countries in cases where such imports threaten the domestic production of the item concerned. An Article 115 authorization temporarily restricts free circulation of goods within the Community and prevents circumvention of national restrictions through imports from other member countries. Most of the existing Article 115 authorizations relate to imports of textiles and clothing under the MFA (Table 25). Article 115 authorizations have also been granted for imports of automobiles, footwear, and other industrial products as well as for agricultural products. Industry-to-industry restrictions on automobiles (e.g., France and the United Kingdom) are not approved by the Commission and consequently are not covered by Article 115. In principle, it would be possible to bypass the French restriction by importing Japanese automobiles from other EC members. In practice, this is prevented by national automobile standards and certification procedures, which are scheduled to be eliminated by 1992.

The criteria for granting Article 115 authorizations were tightened in 1974 and 1979. The trend since 1979 has been in the direction of further tightening. Although the percentage of Article 115 authorizations granted to the total requested has increased, the number of requests has been halved over the period 1980-87. In assessing members' requests, the Commission takes into consideration the evolution of total EC imports of the item concerned relative to the individual member's imports, past patterns of intra-EC trade, as well as the profit position and employment situation of the industry. In principle, recourse to Article 115 would no longer be possible after internal borders disappear upon the completion of the internal market in 1992. This would have implications for the nature of bilateral agreements under the MFA, if it were to be renewed after its expiration in 1991. These implications are being reviewed by the Commission to ascertain the feasibility of replacing national restrictions with EC-wide restrictions.

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1/ Other major industrial countries also maintain residual restrictions.

### 3. GCC cooperation agreement

The Cooperation Council of the Arab States of the Gulf (GCC), which includes Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates, has recently requested the negotiation of a trade and cooperation agreement with the EC providing for a free trade area covering all industrial products, including petrochemicals. In November 1987 the EC Council authorized the Commission to negotiate a two-stage agreement with the GCC. The first stage, concluded on June 15, 1988, includes agreements to increase cooperation in the areas of industry, energy, science, technology, and the environment; 1/ a "standstill" clause preventing the introduction of new restrictions; and the mutual application of MFN treatment. 2/ The second stage would include trade liberalization measures that fall short of a free trade area. This reflects a desire by the EC to maintain sufficient petrochemical production capacity to provide security of supply and concerns of some EC member countries that complete elimination of EC tariffs on their petrochemical industries could harm restructuring efforts in the EC oil refining and petrochemical industries. In exchange, the EC would provide for an infant industry protection clause to benefit the GCC countries. To avoid a reduction in EC protection to its petrochemical industry not matched by similar reductions by the United States and Japan, both parties to the agreement have pledged to promote a multilateral reduction in customs duties applicable to petrochemical products in the Uruguay Round.

Imports of petrochemicals from the GCC countries into the EC are presently governed by the EC's Generalized System of Preferences (GSP) scheme. The operation of the GSP scheme has been the focus of a dispute between the Community and the Gulf Cooperation Council and has hindered the negotiation of a cooperation agreement. Duty free access of "sensitive" products, including petrochemicals, under the GSP scheme is subject to annual quantitative limits. Beyond these limits, duties of 13 percent on petrochemicals are applied automatically for some products or at the request of the domestic industry for others. These limits are typically reached within the first few days of the year, giving rise to complaints by the GCC countries that the Community's GSP scheme is unhelpful to them. The EC Commission, in turn, views the substantial imports of petrochemicals from the GCC countries as evidence that the tariff does not appear to adversely affect GCC exports.

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1/ The EC undertook to help GCC countries diversify their energy, industrial, and agricultural sectors through joint ventures, technology transfers, training, and joint surveys of markets for oil and gas and their derivatives.

2/ MFN treatment presently does not apply to trade between the EC and the GCC countries that are not GATT members; Kuwait is the only GATT member among GCC countries.

4. Lomé Convention (ACP preferences)

The EC has extended duty free access on a nonreciprocal basis to its market as well as financial and technical assistance to 66 ACP countries under the third Lomé Convention (Lomé III). The agreement came into force on March 1, 1985 for a five-year period and superseded previous agreements. 1/ With the accession of Angola to the agreement, the signatories of Lomé III include all the sub-Saharan African countries. Lomé III contained broadly similar provisions and included an increase in EC financial assistance from ECU 5.5 billion under Lomé II to ECU 8.5 billion. A portion of the financial assistance is linked to developments in commodity export receipts of the ACP countries. In addition, the Community is committed to purchase an agreed quantity of sugar exports at a guaranteed price. EC imports from ACP countries account for one fifth of its total imports from non-oil developing countries.

The EC is about to enter into a new round of negotiations with ACP countries to renew Lomé III after its expiry in February 1989. The EC Commission's draft negotiating mandate, subject to the Council's approval, includes a modification in the modalities of financial assistance to ACP countries to include loans in support of structural adjustment efforts. The negotiations are complicated by their coincidence with the Uruguay Round discussions on a possible elimination of tariffs on tropical products, which would eliminate the preferential treatment of ACP exports of such products on the EC market. Another complication is that certain ACP countries have higher per capita incomes than Greece, Ireland and Portugal, yet rely on them for aid.

5. GSP scheme

The EC's GSP scheme provides nonreciprocal tariff concessions to developing countries. The scheme, which operates at the Community level, was introduced in 1971 and renewed in 1981 for another ten-year period. Though available to all developing countries, the benefits of the GSP are in practice mainly utilized by Asian and Latin American countries. Developing countries in the African, Caribbean, and Pacific regions (ACP countries), while legally beneficiaries of the GSP, enjoy more generous tariff preferences under the Lomé Convention. Similarly, most countries bordering on the Mediterranean have more favorable access to the EC market under their EC agreements than under the GSP. The

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1/ The Yaoundé Conventions I and II (1964 and 1971) with African countries were replaced by Lomé I (1976) which included 21 former Commonwealth countries that were invited to join following the United Kingdom's entry into the EC. A successor agreement, Lomé II, was signed in October 1979, a few months before Lomé I expired. Lomé II broadened the scope of the agreement to include provisions relating to payments and capital movements, direct investment, and services. Grants and loans were provided through the EC budget and the European Investment Bank (EIB).