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February 19, 1985

To: Members of the Executive Board  
From: The Acting Secretary  
Subject: Trade Policy Issues and Developments

There is attached for consideration by the Executive Directors a paper on trade policy issues and developments, which has been scheduled for Executive Board discussion on Monday, March 18, 1985.

Background material for this paper is contained in two documents to be issued shortly: "Trade Policy Issues and Developments - Supplementary Material" (SM/85/60, Supplement 1) and "Trade Policy Issues and Developments - Statistical Annex" (SM/85/60, Supplement 2).

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Anjaria, ext. 8357.

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INTERNATIONAL MONETARY FUND

Trade Policy Issues and Developments

Prepared by the Exchange and Trade Relations Department

(In consultation with other departments)

Approved by C. David Finch

February 19, 1985

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## I. Introduction

This paper reviews recent developments in the trade area, and outlines the main issues facing governments in the international trade policy field at present. Supplements 1 and 2 to this paper, issued separately, provide more extensive background analysis and statistical information. 1/ Together, these papers constitute the background material for an Executive Board discussion of trade policies and protectionism in advance of the forthcoming meetings of the Interim and Development Committees. The Managing Director's report to the Development Committee, insofar as trade issues are concerned, will be based on the discussion in the Executive Board of the present paper.

The previous major trade survey by the staff, "Developments in International Trade Policy" (SM/82/136, 7/12/82), was considered by the Board in September 1982. 2/ The Chairman's summing up of that discussion is contained in Buff 82/170 (corrected 10/5/82). Also relevant is the Managing Director's Buff on Trade Issues circulated at the conclusion of the November 1982 GATT Ministerial meeting (Buff 82/229, 12/16/82). Directors have also discussed trade issues in the context of the World Economic Outlook exercises. Moreover, trade policy assessments have been included in brief background papers by the Fund staff for recent meetings of the Development Committee. 3/

This paper is organized as follows. Section II highlights the main features of recent developments that are relevant for a broad assessment of the current stance of trade policies; section III discusses the main issues that will determine the scope and timing of trade liberalization under a possible new GATT round of multilateral negotiations; section IV reviews the role of the Fund in the trade field, and suggests possible improvements; and section V draws together issues for discussion.

As in the 1982 paper, emphasis is on policy developments in the major trading nations as they relate to trade in both industrial and agricultural products. In addition, this survey includes a review of trade policies in developing countries, and, in response to Executive Directors' comments on several occasions, the survey also refers to available quantitative evidence on protectionism wherever possible. 4/

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1/ See SM/85/60, Supplements 1 and 2.

2/ After suitable editing, this paper was subsequently published as IMF Occasional Paper No. 16.

3/ The most recent Fund paper, "Linkages Between Trade and the Promotion of Development," was issued for the spring 1984 meeting of the Development Committee as part of document DC/84-4 (3/16/84).

4/ Special sections on quantification are to be found in the supplementary paper. It should be emphasized that quantification in this area is especially difficult, and that available estimates are subject to many qualifications. This is particularly true in the case of very longstanding restrictions (e.g., textiles and clothing), where it is difficult to identify an undistorted norm for comparison, as well as in the case of very recent measures (e.g., voluntary export restraints on steel between the United States and certain exporting countries), where detailed information on operation may be available only after a considerable time lag.

In assembling materials for this paper, the staff has relied on published and unpublished materials available in the Fund and elsewhere. On this occasion, the staff paper has benefited particularly from the growing body of surveys and studies available in the GATT, the OECD, and the IBRD. Also, the staff has held informal discussions with various official agencies. 1/

## II. The Salient Features of the Present Situation

1. The continued drift toward protectionism poses a threat to the balanced expansion of world trade in the medium term, and to the prospects for sustaining economic recovery.

In the past several years, protectionist pressures and actions increased significantly in most industrial countries. Although Tokyo Round tariff cuts continued, and limited instances of liberalization of nontariff barriers occurred, the overall drift toward protectionism that began in the mid-1970s recently accelerated. Trade restrictions or trade-distorting measures were intensified or imposed not only in the traditionally protected sectors such as steel, textiles and clothing, and agriculture, but they also spread to new sectors such as automobiles and electronics. The notable exception among industrial countries is Japan, which has undertaken a series of important liberalization measures in recent years.

Consumption in product groups subject to nontariff restrictions in 1983 accounted for some 30 percent of total consumption of manufactures in the major OECD countries, compared with 20 percent in 1980. 2/ A recent study 3/ estimated the share of imports restricted by nontariff measures in total imports of manufactures in 1980 at 6, 11, and 7 percent, respectively, for the United States, the European Community, and Japan; restrictions introduced during 1981-83, in terms of 1980 dollar values of imports, were 6 1/2 percent and 4 percent, respectively, for the United States and the EC. Many of the new restrictions applied to Japan and some of the major developing country exporters of manufactures. The OECD estimated that 15 percent of the combined exports of manufactures of five Asian exporters to the OECD countries were subject to trade restrictions in 1980; this proportion rose to 30 percent in 1983. 4/

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1/ In order to obtain information and collect views for this paper, staff teams have held discussions with trade officials in Bonn, Brasilia, Brussels (the EC Commission), Canberra, London, New Delhi, Ottawa, Paris, Seoul, Tokyo, Washington, and Wellington. In addition, a staff team has visited Geneva and Paris for discussions with GATT and OECD officials.

2/ OECD, "Costs and Benefits of Protection," unpublished (November 1984). The proportions were calculated using 1980 values.

3/ Balassa and Balassa, "Industrial Protection in the Developed Countries," The World Economy, Vol. 7, No. 2 (London: June 1984), pp. 179-196.

4/ The exporters concerned were Hong Kong, Korea, Japan, Singapore, and Taiwan Province of China. The 1983 proportion is calculated using 1980 trade weights.

Trade in temperate and competing zone agricultural products (accounting for almost one half of world agricultural trade) largely took place under restrictive and protectionist trade policies.

International trade flows are particularly responsive to cyclical factors. In addition, trade expansion induced by an open trading system feeds back on the growth of output. While it is difficult to establish clearly the relative influence of cyclical factors and the stance of trade policies on the growth of international trade, it is evident that the recent economic recovery has had a strong positive effect on world trade expansion. According to GATT statistics, world trade growth averaged 8 1/2 percent annually in 1963-73; the growth of world output averaged 6 percent. In 1973-83, world trade grew by 3 percent annually, while output grew by 2 percent. In contrast, according to World Economic Outlook estimates, world trade growth in 1984 (9 1/2 percent) significantly outstripped the expansion of output (5 percent). With an expected slowdown in economic growth rates in industrial countries, the growth of world trade is projected to decelerate to 5 1/2 percent in 1985. The prospects are for economic growth in industrial countries in the period until 1990 to remain well below the averages reached in the late 1960s and the early 1970s. While the strength of demand, rather than the stance of trade policy, has been the dominant influence, there is little doubt that the effects of protection on efficient resource allocation have implications for the pace and pattern of world growth of output and trade. These effects may well become more pronounced in a context of relatively modest medium-term growth prospects.

Another aspect of the relationship between trade and growth at present is the unevenness of the economic recovery concentrated in North America. Reflecting strong demand and an appreciating dollar, U.S. imports (in terms of value) grew by 31 percent in the first nine months of 1984, compared to the corresponding period in 1983, with all country groups showing significant increases. In particular, U.S. imports from Japan and the group of major exporters of manufactures grew very rapidly--by 48 and 41 percent, respectively. Major exporters of manufactures, led by Brazil, Korea, and Singapore, expanded their market share from 10.4 percent to 11.2 percent of U.S. imports. 1/ Other non-oil developing countries, however, lost significant market shares. 2/ Contrary to earlier expectations, however, the strong recovery in the United States was not accompanied by reduced protectionist pressures, either in the United States itself, or to any significant degree among its trading partners, whose exports increased sharply as a result of the upsurge in U.S. import demand. Indeed, the persistence of high unemployment in many industrial countries made it more difficult to resist protectionist pressures and weakened the impulse for trade liberalization, especially in employment-sensitive sectors.

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1/ Had their 1983 market share remained unchanged, the combined exports of this group of developing countries would have been about \$2 billion, or 7 percent lower over the first nine months of 1984.

2/ Exports of non-oil developing countries, other than the major exporters of manufactures, would have been about \$5 1/2 billion (13 percent) higher, had they maintained unchanged 1983 market shares.

These developments are a source of continuing concern, particularly because the rise in protection is concentrated in sectors where comparative advantage is shifting, and has taken the form of quantitative restrictions which directly limit trade expansion on the basis of comparative cost, and, by impairing the functioning of the international price mechanism, create uncertainties among investors, particularly with regard to expansion of export capacities. In a dynamic context, the longer term adverse effects of protectionism on investment, efficiency, and growth are thus likely to be more severe than the immediate effects on exports of certain countries or groups of countries. The growth of public subsidies to enterprises in industrial countries has also continued, and is a source of concern, both because of the need to redress fiscal imbalances and because of the trade distortions that they create.

2. An aspect of particular concern about the drift toward protectionism is the frequent recourse to bilateral, sector-specific trade measures which harm the multilateral trading system based on the GATT and go against the principle of comparative advantage that forms the basis for efficient trade expansion.

The staff survey confirms that the vast majority of measures applied in response to difficulties in specific sectors have a strong bilateral element designed to restrict import competition from countries with a comparative cost advantage. Restraints, administrative guidance, and floor price systems apply to 40 percent of Japan's exports to the United States and the Community, and to about 20 percent of its total exports. The Multifiber Arrangement (MFA), which derogates from GATT principles by authorizing discriminatory restrictions, has been made progressively more restrictive against developing country exporters, and, within this group, against the largest suppliers. Notwithstanding the developing countries' increase in the share in world exports of textiles and clothing in the aggregate, the existence of the MFA has prevented them from exploiting totally their comparative advantage potential. For example, the OECD estimated the compression of imports of textiles and clothing from non-OECD sources in 1982 and 1983 at 10 percent in volume terms. <sup>1/</sup>

As the more advanced developing countries acquire the skills and investments to diversify exports toward more sophisticated manufactured products, restrictions against them have tended to multiply. This not only impedes the export prospects of the developing countries directly affected, but also slows the wider process of specialization and diversification, thus affecting the "smaller" developing country exporters

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<sup>1/</sup> The OECD study estimated import compression as the difference between actual imports and imports predicted by a model based on 1966-81 data. It noted that, subsequent to the implementation of the Multifiber Arrangement in 1973, OECD imports of textiles and clothing became almost totally unresponsive to price signals. When based on 1966-72 data, the model estimated that 1982-83 import volumes from non-OECD sources would be at least twice as large as the observed magnitudes.

severely. Bilateral, sector-specific restrictions impede competition, not only between producers in industrial countries and lower-cost suppliers in developing countries, but also among the developing countries themselves. Investment opportunities may not be fully exploited in developing countries lacking security of access to markets abroad for future expansion of exports.

Recent experience in the agricultural sector is similar. It illustrates that it may not be possible to contain the effects of bilateral measures to the intended countries. Agricultural trade frictions have revolved around the operation of the Community's Common Agricultural Policy. Frictions have been aggravated by subsidized sales under U.S. "blended" credit arrangements, which are partly designed to maintain the traditional U.S. market share vis-à-vis the Community. Although such competition for sales in third markets has been viewed as a legitimate practice designed to encourage reform of the Common Agricultural Policy, it has also, inevitably, put pressures on other efficient producers to match the more beneficial credit terms.

3. An underlying reason for the continued drift toward protectionism is a lack of full appreciation of the costs of protection and the economic arguments for liberal trade.

The staff survey revealed that the reasons given for the failure to reverse the drift toward protectionism range widely. They include factors such as exchange rate relationships; trade or current account deficits; "unfair" foreign trade practices; weak economic recovery; structural rigidities; high rates of unemployment; the perception that departures from liberal trade policies have been relatively insignificant; developing countries' need for infant industry protection; the need for protection in "new" industries such as high technology; and the special characteristics of a sector such as agriculture. These arguments explain some of the factors underlying the strength of protectionist pressures, but do not take account of the costs of protection, particularly where measures are not "temporary," as originally intended. In the final analysis, the major explanation for the continued resort to protection is the absence of sufficient political will to resist protectionist and bilateral measures.

It is generally acknowledged that concentrated producer interests can lobby strongly for protection, while the interests of comparatively less organized consumers and taxpayers are more diffuse and spread throughout the economy. That it is technically and politically feasible to give greater weight to interests of consumers and trading partners is illustrated by the recent U.S. decision to reject import relief for copper producers, even though the proposed restrictions would have been consistent with domestic and international norms. For a better and more consistent balance between national producer and consumer interests to be effective, governments could make concerted efforts to publicize the costs of protection, and to take them into account more systematically

in trade policymaking. For example, a recent study <sup>1/</sup> calculated the average subsidy paid by the consumer for each job protected in the United States as a result of tariff and nontariff restrictions applied on television receivers, footwear, and steel in the 1970s. It concluded that the annual cost of protection, in terms of the subsidy from the consumer, reached almost six times the cost of compensation per job in the television industry, more than nine times in footwear, and four-and-a-half times in steel.

4. The smooth functioning of the international adjustment process requires an open trade and payments system.

Trade protectionism hinders smooth balance of payments adjustment, while, if exchange systems are restrictive, the balanced expansion of world trade and sustained economic growth are difficult to achieve. Although this shared complementarity of the monetary and trade systems has been recognized by the Fund and the GATT, large movements in exchange rates have, in recent years, given rise to concerns among some policy-makers about the feasibility of maintaining liberal trading conditions. By creating greater market uncertainty, exchange rate volatility may give rise to protectionist pressures. However, a recent Fund staff study, while acknowledging the difficulties of assessing the impact of exchange rate volatility on world trade, found no statistically significant link to support the hypothesis that greater volatility since the early 1970s had impeded world trade. <sup>2/</sup>

Across-the-board protectionist measures have been avoided in the industrial countries because it is widely acknowledged that trade restrictions and protectionism are inappropriate responses to exchange rate developments. In specific sectors, however, protectionist pressures have sometimes proved difficult to resist. Sectors where nontariff measures have been introduced are often structurally weak, and probably would have pressed for protection even in the absence of exchange rate movements. Protectionist pressures have risen significantly in the United States, which has also experienced a sharp rise in the value of the U.S. dollar against other major currencies, and substantial trade deficits in the past two years. With a worldwide surplus capacity in

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<sup>1/</sup> M.C. Munger, "The Costs of Protectionism: Estimates of the Hidden Tax of Trade Restraint," Center for the Study of American Business, Working Paper No. 80 (St. Louis: July 1983).

<sup>2/</sup> Exchange Rate Volatility and World Trade, IMF Occasional Paper No. 28 (Washington, D.C., 1984). This study was prepared in response to a request by the GATT CONTRACTING PARTIES; see also section IV.3 below. A subsequent study by the staff of the Federal Reserve Bank of New York concluded that exchange rate variability might have reduced the volume of international trade in manufactured goods in the United States and Germany. M.A. Akhtar and R. Spence Hilton, "Effects of Exchange Rate Uncertainty on German and U.S. Trade," Federal Reserve Bank of New York, Quarterly Review, Spring 1984. The Fund staff is currently engaged in replicating the tests used in this study for other countries.

several sectors, the faster U.S. recovery encouraged the sharp rise in U.S. imports, and protectionist pressures were felt most severely in traditional sectors where structural adjustment was weak or insufficient.

Exchange rate movements reflect financial flows as well as trade flows, and the importance of exchange rates that correspond to underlying economic fundamentals is unquestioned. Monetary and fiscal policies that influence savings and investment, in particular real interest rates, are important determinants of current account balances. Even though exchange rate movements can improve or undermine industrial competitiveness, the appropriateness of given exchange rate relationships cannot be assessed solely with reference to the size of trade imbalances. Exchange rate developments may explain some of the pressures for protection; they do not justify either generalized or sectoral protection.

5. Bilateral protectionism is a serious obstacle to meaningful trade liberalization, because it lacks transparency and creates vested interests among exporters and importers for the preservation of the status quo.

Many of the current trade restrictions are applied in the form of voluntary export restraints (VERs) or informal understandings reached through bilateral bargaining between the importing and the exporting country by the governments or industries concerned. Such measures also create incentives for new bilateral measures to proliferate as producers in other sectors press for similar restrictions.

At the microeconomic level, bilateral market-sharing arrangements are perceived to have many attractive features. For the domestic producer of the import-competing product, a bilateral restriction shelters his market from the more efficient foreign producer, and may help him to maintain sales and profit margins. For the exporter, a voluntary export restraint arrangement, which is frequently specified in terms of quantity, provides an assured outlet for his product and, depending on the relevant elasticities, may enable him to capture the rents arising from the ability to raise the export price to the extent of the difference between the international price and the higher domestic price in the importing country. The allocation of export licenses on the basis of historical market shares may inhibit export sales by new firms. The exporter may resist converting a bilateral export restraint arrangement to a more transparent and economically more efficient tariff, as it could lead to a loss of rents; reverting to a free-trade situation is resisted because it could lead to a loss of market share as well. Exporters not initially restricted by a bilateral arrangement may in fact welcome the arrangement, as it provides at least a short-term opportunity to expand sales and increase market shares. If realized, however, further pressures inevitably develop to make bilateral arrangements more restrictive and expand them to cover more suppliers and close substitutes for the products initially restricted. Liberalization of such restrictions may be resisted both in exporting and importing countries because they can be rationalized as offering greater "security" in international trade flows than would an unrestricted trade regime. Cartelization of international trade may thus be encouraged.

Cases of alleged "unfair" competition have been increasingly settled through market-sharing arrangements rather than through the imposition of GATT-authorized antidumping or countervailing duties. This has tended to further weaken international trade discipline, to the extent that exporters are encouraged to acquiesce in such bilateral arrangements rather than to eliminate the distortions arising from the dumping or subsidy practices themselves.

6. The recent revival of interest in bilateral free-trade areas has raised some questions about the prospects for strengthening the multilateral system.

The possibility of establishing a free-trade agreement between Canada and the United States has been under discussion in academic and policy circles for several years, particularly on the Canadian side. Recent U.S. legislation authorizes the U.S. government to negotiate bilateral free-trade agreements with Israel, Canada, and possibly other countries. In several other industrial and developing countries, concerns have been voiced about the possibility of trade diversion if bilateral trade liberalization between major trading nations is achieved at the expense of the most-favored-nation principle.

GATT rules endorse the creation of customs unions and free-trade areas under certain conditions, and several of them have been in existence for many years. The recent concerns are related to the possible impact of new bilateral agreements involving one or more major trading nations on the prospects for global trade liberalization on a nondiscriminatory basis. So long as tariffs were the main instrument of protection, the assessment of the costs and benefits of free-trade areas was relatively straightforward, as was the application of the compensation principle under the GATT to third countries adversely affected by such limited trade liberalization. In the present situation, however, free-trade areas based solely or primarily on zero duties on merchandise trade would be of more limited significance, owing to the already low level of average MFN tariffs in the industrial countries. If, however, free-trade areas involved the negotiation between agreement countries of reciprocal lowering of nontariff barriers, questions would arise (1) whether such free-trade areas would, in practice, give rise to some form of increased nontariff restrictions against third countries; (2) whether the technical and political difficulty of lowering nontariff restrictions between free-trade partners is such as to make it feasible, with a relatively small additional effort, to extend the same treatment to all countries; and (3) whether new free-trade agreements at this juncture would divert the attention and interest of major trading nations from the multilateral trading system.

7. Many developing countries generally maintain relatively complex and restrictive trade regimes; their simplification and liberalization would promote greater efficiency of resource use and contribute to economic integration between developed and developing countries and also among developing countries.

With some notable exceptions, developing countries have traditionally relied heavily on tariff and nontariff barriers to trade. Although, at an earlier stage, the adoption of a protectionist policy may have been considered necessary to stimulate economic development, experience suggests that protection often went considerably beyond what may have been justified on infant industry grounds. Balance of payments constraints have influenced the stance of trade policy to an important degree. Recourse to countertrade arrangements has also increased. <sup>1/</sup>

Developing countries often resort to both trade and payments restrictions, and it is therefore difficult to identify the incidence and effects of trade policies per se in these countries. The staff conducted a survey of a sample of 35 developing countries on the basis of information available in the Fund. The survey showed that, between 1978 and 1983, there was relatively little overall change in the restrictiveness of their exchange and trade systems. In terms of their share in developing country trade, about one third of the sample increased reliance on restrictions, restrictive systems were liberalized in about two fifths, and there was no significant change in restrictiveness in the remainder. This overall result must be seen in the context of the balance of payments difficulties of developing countries in this period. Only a few countries relied primarily on tariff protection; most used a combination of tariffs and nontariff trade restrictions.

The limited comparable information available on tariff levels broadly indicates that developing countries maintain a high average statutory level of tariffs, and that, with some notable exceptions, this has not changed significantly in recent years. Fiscal considerations are very important in determining tariff policy in many developing countries. Nontariff restrictions, and especially quantitative import restrictions, are widely used in developing countries, often in conjunction with industrial licensing and foreign investment policies. Statutory tariffs are prohibitive in some sectors, but import licenses are frequently granted with substantial exemption from the statutory tariff in accordance with established sectoral objectives. Such a system may exacerbate the dispersion of de facto tariffs and thus increase allocative distortions. In the dozen developing countries for which comparisons between 1983 statutory and actual average import duty rates were available, the scope of import duty exemptions was limited to 25 percent of imports or less in only one or two cases; in most developing countries, at least one half or more of imports benefited from duty exemptions.

It is questionable whether, in practice, high trade protection in developing countries is limited to infant industry considerations. In some sectors, a number of developing countries have a comparative advantage without the need to rely on protection. For example, according

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<sup>1/</sup> A recent estimate suggests that countertrade arrangements may account for as much as 5 percent of world trade. See Gary Banks, "The Economics and Politics of Countertrade," The World Economy, Vol. 6, No. 2 (June 1983).

to a GATT survey of 21 developing countries, the combined average tariff level for textiles and clothing was less than 10 percent in one case, and ranged from 10 to 25 percent in 3 cases, from 25 to 50 percent in 6 cases, and exceeded 50 percent in 11 cases. The same study reported that, of 22 developing country markets surveyed at the end of 1983, only 4 (Hong Kong, Macao, Malaysia, and Singapore) reported no nontariff measures on imports of textiles and clothing. Moreover, in textiles and clothing there was a modest positive correlation between the level of tariffs and the number of nontariff measures.

The scope for further trade liberalization by developing countries therefore remains considerable, particularly if both import-competing and export-oriented domestic production are to benefit from more exposure to foreign competition and realize the longer term gains from specialization and economies of scale. In some sectors in developing countries, some tariffs or nontariff restrictions may be redundant in an economic sense, and rationalization of protection may, in the first instance, involve the removal of these redundancies.

The prevalence of protectionist pressures in the major trading nations, and their failure to avoid the drift toward protectionism, has weakened efforts to mobilize domestic support for a more open and rational trading system in developing countries. At the same time, the maintenance of visibly high trade restrictions in developing countries complicates the argument for trade liberalization in those sectors in industrial countries. Thus, protectionism in industrial and developing countries tends to feed on itself, and compounds the difficulties of forging an international consensus on mutually beneficial trade liberalization.

8. A number of developing countries have recently taken important steps toward liberalizing their trade regimes in conjunction with the adoption of comprehensive adjustment programs; the success of these efforts will depend on their comprehensive and sustained efforts to pursue appropriate domestic policies and on the openness of markets abroad.

There has been growing recognition in recent years that economic growth in developing countries can be enhanced by the pursuit of more open trade policies. Thus, balance of payments adjustment efforts have been directed not only at bringing aggregate demand more in line with supply, but also at encouraging improved supply responses over the medium term throughout the economy, by greater reliance on the price mechanism. More export-oriented growth strategies involve reduced reliance on production at high resource cost for the home market, and greater emphasis on price incentives for competitive production. This shift in policy emphasis is by no means generalized to all developing countries.

The extent and nature of steps taken by developing countries toward liberalization has varied from country to country, depending on prevailing balance of payments pressures, the extent of the distortions, and the

scope of corrective domestic policies that the authorities were prepared to introduce. In several cases, trade liberalization was an important element in the adjustment efforts supported under Fund and IBRD programs. In a number of heavily indebted countries, external payments problems had developed to the point where sizable external payments arrears had emerged, and the first priority was to restore a degree of normalcy in the payments system through the reduction of arrears and the consolidation of external debt service payments. In other developing countries, the external imbalance, while serious, was not critical, and trade liberalization could be launched without delay. In a few instances, countries initiated more open trade policies before introducing adjustment programs, and the programs helped support and reinforce their liberalization efforts. In all cases, the pursuit of appropriate exchange rate policies was a critical element in the corrective policies pursued. Where complex and highly restrictive trade and payments systems had been introduced as a means of avoiding or delaying the correction of an overvalued currency, the subsequent adjustment effort eased balance of payments pressures, thus improving prospects for future liberalization.

Each of the actual examples of liberalization contains some of the elements described above. <sup>1/</sup> In Brazil and Mexico, an immediate priority was the correction of a severe currency overvaluation, and the orderly settlement of external arrears. As the adjustment programs take hold, these countries are taking significant steps toward reducing reliance on nontariff trade barriers, and are examining the modalities of removing excess protection of domestic industries and rationalizing the tariff structure. Reliance on quantitative restrictions was also reduced in India and Pakistan, while, in Korea and Thailand, trade liberalization included reduction of both tariff and nontariff barriers. In contrast, liberalization in Malaysia consisted mainly of a lowering of tariffs. The Korean example is of particular interest because trade liberalization will be phased in over a number of years, in a manner designed to permit industries to adapt progressively to increasing foreign competition. By the end of 1988, the scope of Korea's discretionary import licensing and the height of the tariff are not expected to be substantially higher than in some OECD countries. Several developing countries have undertaken to reduce or freeze their export subsidies under the GATT code on subsidies.

A crucial result of successful trade liberalization in developing countries is to encourage a shift of resources from import-substituting to export-oriented production. Two critical requirements must be met if this shift is to be more than transitory, and be allowed to have the desired response on investment. First, trade liberalization must be accompanied by the sustained pursuit of sound domestic financial and economic policies. For example, trade liberalization may entail greater reliance on the price mechanism, including more market-related pricing, exchange rate, and interest rate policies. Second, the success of efforts to increase export orientation must not be frustrated by foreign

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<sup>1/</sup> Section VI of this paper includes an assessment of the trade policy content of Fund programs.

trade barriers. The lack of assurance of open markets, as evidenced by the drift toward protectionism, is an impediment to developing countries' efforts to promote growth based on comparative advantage.

9. More open trade policies in industrial and developing countries would contribute to a higher level and improved sectoral composition of foreign direct investment flows to developing countries, and thus improve the balance of payments adjustment process and efficiency in the allocation of world savings.

Foreign direct investment flows to developing countries are influenced by a variety of factors and policies, including, importantly, the host country's economic policies. <sup>1/</sup> An issue of particular importance in determining the composition of foreign direct investment flows is the extent to which the host country's policies favor import-substituting production, or whether they also encourage the expansion of exports. High levels of tariff and nontariff barriers, particularly in developing countries with large domestic markets, encourage direct investment inflows into manufacturing for the domestic market, while more open trade policies (e.g., in Singapore) encourage production for export markets. A corollary of the recent shift to more open trade policies in some developing countries has been a liberalization of policies to attract a greater inflow of foreign investment. To the extent that the additional investment flows are directed toward production for export markets, industrial countries' willingness to absorb imports from developing countries in sectors where they have a comparative advantage will be critical, both in encouraging greater reliance by developing countries on private direct investment, and in reinforcing the pursuit of more open trade policies by developing countries.

### III. Prospects for Global Trade Liberalization

Since the last session of the GATT CONTRACTING PARTIES in November 1984, a broader international consensus has begun to emerge on the need to launch a new round of multilateral trade negotiations under GATT auspices to deal with problems facing the international trading system. Although it is premature to predict the timing of such negotiations, an assessment may be made of the key areas that will determine the scope and content of trade liberalization.

1. Structural adjustment is at the core of several current trade policy issues

Structural adjustment, and the role of government intervention in adaptation to competitive forces, strongly influence the stance of trade policies. Failure to adapt to shifts in demand, technological change, and productivity improvements, generate protectionist pressures which,

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<sup>1/</sup> "Foreign Direct and Portfolio Equity Investment in Developing Countries," SM/84/145 (6/26/84).

unless resisted, are translated into progressively restrictive trade policies. Policymakers, in principle, have long recognized the link between open trade policies and the promotion of adjustment. Indeed, GATT rules are based on two main propositions regarding these links. One is that a liberal trade system is necessary to allow the effects of shifts in comparative advantage to be felt across national boundaries over time. Thus, protection of national industries through tariffs rather than quantitative restrictions is permissible under GATT rules. Successive trade negotiations have aimed at lowering protection and thus increasing the exposure of economies to foreign competition. The other proposition derives from the principle that a safety valve should permit countries to impose restrictions on a temporary basis when domestic industries face unforeseen difficulties as a result of previous trade liberalization. However, recourse to such safeguard measures is subject to strict guidelines to prevent abuses. In practice, unauthorized bilateral restrictions have tended to proliferate, and the "safety valve" has often been misused.

A report by a special OECD group on positive adjustment policies adopted in 1982 suggested criteria that should be adopted by governments to promote adjustment. A working party on structural adjustment in the GATT concluded recently that "the main contribution that the CONTRACTING PARTIES could make to the adjustment process would be to abide by their obligations under the GATT." <sup>1/</sup> In 1984, the GATT secretariat concluded that structural adjustment problems were not fundamentally different in the textiles and clothing sectors than in other sectors. <sup>2/</sup>

These advances in elaborating the links between trade and adjustment have thus far had a limited effect on actual trade policy formulation. A central problem is how to define the appropriate role of government intervention in promoting more efficient resource allocation through the use of instruments such as tax policies, government subsidies, anti-trust legislation, labor legislation, and government ownership of production facilities. Structural adjustment issues have special relevance for trade policy in four areas.

First, in the established manufacturing sectors in the main industrial countries, such as textiles, clothing, and steel, observed losses of employment and underutilization of capacity are sometimes considered as providing sufficient evidence of an ongoing adjustment. For example, employment losses occurred in the textiles sector in industrial countries throughout the postwar period, when the sector was heavily protected. A recent GATT study notes that these reflect in part the incentive for firms to adopt more labor-saving innovations. Focusing on employment trends in declining sectors obscures the costs of lost job opportunities in other, more efficient industries. Also, increases in the market share of developing countries in certain sectors do not necessarily indicate

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<sup>1/</sup> GATT document L/5568 (10/20/83).

<sup>2/</sup> GATT, Textiles and Clothing in the World Economy (Geneva: July 1984), p. 12.

that trade restrictions have been ineffective. For example, developing countries' share of world exports of textiles rose from 34 percent in 1973 to 46 percent in 1982, and their share in clothing exports rose from 30 percent to 40 percent. Since this took place with protection, the implication is that the cost advantage of developing countries was such that they could have captured an even larger share of the market, thus promoting a more efficient expansion of world trade.

Second, in the area of agricultural policies, there is a greater appreciation among industrial countries of the unsustainable budgetary costs of open-ended farm price or income support programs, and initial steps have been taken in the European Community, Japan, and the United States toward bringing these under control. In addition, the GATT Committee on Trade in Agriculture recently reached understandings on the need for a more coordinated approach to agricultural trade barriers. It established a framework within which future negotiations on agricultural trade liberalization could be conducted. These recent advances are welcome, but they must be viewed against the background of significant and increased frictions that have characterized trade relations in agriculture among the major trading nations in the past three years. The reform measures implemented thus far are not sufficiently far-reaching to offer the prospect or assurance that the problems arising from structural surpluses, and their disposal in world markets, will be resolved in the medium term.

A third--and relatively new--issue concerns the role of trade policy in shaping the establishment of new high technology industries in the industrial countries. The products range from new consumer goods with a high technological content, such as video cassette recorders and digital audio components, to products with office or industrial applications, such as computer chips, advanced computers, office automation equipment, and numerically controlled machine tools. An issue of particular relevance to trade policy in this sector is the appropriate degree of public support for research and development. Such support is sometimes said to "create" comparative advantage, and is included under the heading of "targeting." In order to forestall the spread of trade barriers in this sector, the United States has proposed a GATT study on high technology. Given the different attitudes of governments concerning their role in promoting industrial development, this proposal has not yet been adopted, and trade frictions have emerged in high technology goods.

The fourth area in which the links between trade policy and structural adjustment require clarification and strengthening concerns the trade policies of developing countries. The role of more open trade policies in inducing faster growth and greater efficiency is frequently not sufficiently acknowledged, and the adjustment issue in developing countries is sometimes viewed as a problem caused by exogenous factors, including trade restrictions applied in the industrial countries. Limiting protection strictly to infant industry considerations and progressively eliminating protection as the industry matures would improve the adjustment process in developing countries.

2. Trade relations between developed and developing countries will influence prospects for trade liberalization

The second major issue for the next round of trade negotiations is trade between developed and developing countries. At the last session of the CONTRACTING PARTIES in November 1984, developing member countries of the GATT issued a statement setting forth their main views: 1/ (a) they considered that the industrial countries had not observed the principle of the GATT ministerial declaration to make determined efforts to resist protectionist pressures and avoid measures inconsistent with GATT principles; (b) they urged the abolition of restrictions inconsistent with the GATT and the completion of the GATT work program agreed by the ministerial meeting; and (c) they declared their intention to participate in negotiations that would concentrate on removing restrictions on merchandise trade impeding developing countries' exports, without extending the scope of GATT rules to cover new areas such as services.

Statements made by several industrial countries at the GATT session, in contrast, urged an early launching of negotiations to liberalize trade in goods and services, and fuller participation of the developing countries in the new round. The most controversial issue during the GATT session was the question of the possible inclusion of services in the new round. In the compromise that was developed, some advance was made on future studies of the services sector by the GATT secretariat. However, the Chairman of the CONTRACTING PARTIES announced that this compromise did not prejudice any country's position on the possible inclusion of trade in services in the multilateral trading system.

The framework of rules governing trade relations between developed and developing countries has been under more or less continuous discussion since the inception of the GATT. Provisions have been incorporated in the GATT to allow developing countries to maintain trade restrictions for development purposes. In addition, in 1966, the GATT was amended by including Part IV in the General Agreement, whose main feature was an acknowledgement by the CONTRACTING PARTIES that developing countries should not be required, in the process of trade liberalization through successive negotiations envisaged by the framers of the GATT, to offer reciprocal concessions to the developed countries. 2/ Moreover, in the conduct of trade policy, developed countries were enjoined to take account of the special needs of developing countries, for example, in undertaking liberalization or imposing trade restrictions. As a result of these provisions for special and differential treatment of developing countries, the issue of the best way to encourage the expansion of trade between developed and developing countries came to occupy a special place

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1/ GATT document L/5744 (11/23/84).

2/ The GATT enabling clause introduced in 1979 states that the "developed countries do not expect the developing countries, in the course of trade negotiations, to make contributions which are inconsistent with their individual development, financial and trade needs."

in multilateral trade negotiations. With the export successes and industrial development of several developing countries, developed countries have suggested that developing countries should gradually assume a more central place in the multilateral trading system, in particular by taking an active part in the formulation and improvement of trade rules and by undertaking GATT obligations commensurate with their development needs.

Developing countries have over the years participated more actively in trade negotiations. During the Tokyo Round of trade negotiations in 1973-79, several major exporters among the developing countries participated in drafting the trade codes being negotiated. At the end of the Tokyo Round, 21 developing countries, whose exports account for three fourths of the combined exports of developing GATT members, adhered to one of the two protocols on tariff concessions negotiated in the Round, and 24 countries, with a nearly 80 percent share in developing country exports, signed one or more of the GATT codes on nontariff barriers.

Developing countries receive trade preferences from developed countries. Over the years, there has been considerable debate on strengthening preferential treatment versus trade liberalization on a nondiscriminatory basis. This important issue remains unresolved. In their 1982 report, the Commonwealth Expert Group addressed this issue as follows:

The apparently conflicting objectives of preferences and non-discrimination, and the trade arrangements reflecting these orientations, have been considered with a view to identifying areas for rationalization. The long-term objective must be non-discrimination. We do not start with a tabula rasa, but with historically determined regional preferences to developing countries. Some countries are likely to gain more from a universal application of non-discrimination than they would lose from giving up their preferences: if, however, universal non-discrimination cannot be guaranteed, these countries cannot be expected to enjoy losing advantages which they now possess. 1/

Given the impasse on reciprocity and special and differential treatment, a pragmatic and flexible approach appears inevitable. How the multilateral trade negotiations handle the delicate and complex issues involved in North-South trade will thus be a major determinant of the future strength of the multilateral trading system.

3. Decisions on strengthening the GATT could reinforce the viability of the multilateral trading system

The third main issue concerns the extent to which GATT discipline could be strengthened, so that the liberal trading system could better withstand any strains that may arise as a result of trade friction, slow economic growth, and the more diverse interests of governments in a multipolar world.

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1/ Commonwealth Secretariat, Protectionism: Threat to International Order (London: 1982), p. 101.

In successive rounds of trade negotiations, considerable attention has been focused on this question. In the past 35 years, significant success has been achieved in lowering tariff barriers and introducing a measure of discipline on nontariff restrictions. International trade rules have been adapted to meet the challenges posed by new issues--such as the inclusion of Part IV in the General Agreement, the tighter international discipline on the use of export subsidies, and the conclusion of GATT codes on a variety of nontariff measures during the Tokyo Round. At the same time, the recent developments outlined in section II obviously pose new challenges. GATT members agreed in 1982 to avoid introducing measures inconsistent with the GATT and to roll back such existing restrictions. In fact, there has been little progress on the standstill and rollback.

In recognition of the broader problems of the multilateral trading system, the Director-General of the GATT, late in 1983, appointed a Study Group on the Problems of the International Trade System--under the chairmanship of Mr. Fritz Leutwiler, to "identify the fundamental causes of the problems afflicting the international trading system and to consider how these may be overcome during the remainder of the 1980s." Its report is expected to be published shortly.

A crucial point, as governments consider issues relating to the trading system, is the extent to which the GATT could be strengthened as an international body with resources and authority to influence trade policy formulation more directly. Owing to the failure of plans to establish an International Trade Organization soon after World War II, the General Agreement on Tariffs and Trade came into existence by virtue of a Protocol of Provisional Application. As a result, the functions of the GATT secretariat have not been elaborated in detail. <sup>1/</sup> Bilateral, sector-specific trade restrictions have proliferated not only because governments of exporting and importing countries have been unable to withstand the pressures for such bilateral accommodation, but also because the international interest in preserving the system is not brought to play before the process of accommodation reaches the stage of negotiated decisions, and frequently not even then. Improvements in the decision-making process that give a more effective voice to the international interest in a liberal trading order will add a critical element in ensuring more open trading conditions on a lasting basis. Regardless of the specific features of the rules on international trade, a more effective surveillance and monitoring mechanism based in the GATT will be required.

Toward this end, two elements are important: an increase in national governments' accountability for their trade and trade-related actions, as well as in the international community's adherence to the GATT system. This could be advanced in the relatively near future by

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<sup>1/</sup> The functions of the GATT secretariat include "examining proposals submitted for the agenda of the CONTRACTING PARTIES, consulting contracting parties concerned, and submitting reports to the CONTRACTING PARTIES."

providing the GATT secretariat with a mandate to undertake independent analysis, to propose options and solutions, and to advise on the implementation of trade policies on its own initiative, as well as at the request of contracting parties. Over the longer run, a strengthened GATT could involve establishing a stronger executive committee of GATT members for more regular formulation and interpretation of policy decisions to which national governments would be answerable. Another aspect of a strengthened GATT could be an improved dispute settlement procedure and provisions for following up settlements.

The effectiveness of improvements such as these would require the necessary political will and national government support.

4. Interlinkages within a global round of negotiations will have a bearing on the scope and timing of liberalization

The fourth main issue is how a new round of trade negotiations will link different elements of the negotiations, and if it will be possible to proceed with implementation of actions to liberalize trade barriers in some areas, even before the conclusion of the negotiations as a whole.

Central to all recent multilateral trade negotiations has been the principle of reciprocity of mutual trade concessions. With the inclusion of nontariff barriers in trade negotiations, the effort to achieve "overall reciprocity" encourages trade-offs across a broader range of issues and trade barriers than would be possible if governments sought to achieve a narrower balance of concessions in each area under negotiation. In principle, the concept of overall reciprocity thus makes it possible to achieve greater trade liberalization.

Although overall reciprocity is also likely to be a guiding principle for any future trade-negotiating round, it remains unclear how it will be translated into practice. Several features of the next round are likely to add to the technical and political complexities of achieving an acceptable mutuality of concessions on the basis of overall reciprocity. First, on issues such as safeguards and agricultural trade restrictions, the formulation of generally acceptable international discipline has eluded governments for several years. Discussions on strengthened discipline on safeguards, launched in the context of the 1973-79 Tokyo Round negotiations and continued in the GATT subsequently, have failed to develop a generally acceptable standard for whether temporary import restrictions designed to protect domestic industry from injurious import competition should be permissible only if applied on a nondiscriminatory basis, or whether selective (i.e., discriminatory) restrictions should be permitted against countries whose exports are judged to be primarily responsible for the injury to the domestic industry. Meanwhile, in the past decade, "gray area" and GATT illegal measures such as bilateral export restraint arrangements have proliferated. In the area of agricultural trade, the recent compromise in the

GATT considerably advances the prospects of meaningful trade liberalization. Nevertheless, whether issues such as safeguards and agricultural trade that remain largely unresolved from the previous trade negotiating round could or should be dealt with more expeditiously than other areas of interest in a new round has not yet been addressed or resolved.

Second, the issue of possible interlinkages in broader trade liberalization arises in the context of the Multifiber Arrangement, currently scheduled to expire in July 1986. GATT discussions on the future of the Multifiber Arrangement are expected to begin in mid-1985. The question that many governments face is whether decisions taken for textiles and clothing should form part of the new trade negotiating round, or be arrived at and implemented without directly linking possible liberalization in this sector with progress in other areas. Given that restrictions in this sector are directed specifically toward regulating exports of developing countries, the manner in which this issue is resolved could have a broader bearing on trade relations between developed and developing countries.

Finally, how possible negotiations in so-called "new" areas, such as trade in services, high technology goods, and others, are linked to the more traditional negotiations on tariff and nontariff trade barriers, is also likely to influence the pace and content of trade liberalization in the new round. A liberal environment for services is, in principle, desirable as a means of promoting the expansion of economic activity based on comparative advantage. Indeed, obligations of Fund members to maintain a payments system that is free of restrictions apply to all current transactions, including services. As a trade policy issue, however, it is widely acknowledged that preparatory work in the "new" areas is not yet sufficiently advanced to permit an early start to actual negotiations. If this perception is valid, the question arises how the pace of overall negotiations will be influenced by the decisions made in these areas. Given the strongly divergent views of some governments on the feasibility and desirability of negotiations in "new" areas, a generally acceptable formula for dealing with them will be technically and politically difficult to devise.

Each of the successive rounds of trade negotiations has involved resolution of increasingly complex issues. The Kennedy Round of trade negotiations, launched in 1964, required four years to complete; the Tokyo Round, which placed even greater emphasis on liberalizing nontariff barriers, took place over a six-year period. There is little doubt that a new round is likely to entail considerably more complex trade-offs. Even if substantive new negotiations could be launched within the next 12-18 months, it is difficult to be confident that the actual liberalization of trade resulting from the new round will take place before the end of this decade, or even in the early 1990s. A critical issue for governments is how this process can be accelerated.

#### IV. Role of the Fund

In response to concerns expressed by Executive Directors during the major discussion on trade policy developments 2 1/2 years ago, the Fund management and staff have stepped up their efforts to encourage Fund members to pursue liberal trade policies. A central assumption underlying these efforts continues to be that the Fund can make its contribution most effectively by respecting the existing institutional distinction between the Fund's responsibilities in the payments field and the GATT's role and competence in the trade field. This section reviews the areas in which the Fund's main efforts in the trade field have been focused, and suggests possible further steps the Fund could take.

##### 1. Fund surveillance

###### a. Steps taken

An innovation stemming from the Executive Board discussion in September 1982 was the increased focus on trade policy matters in Article IV consultations, in particular with the major trading nations that heavily influence the openness of the trading system as a whole. In recent years, staff reports on Article IV consultations have included, more systematically than before, assessments of the trade policy stance of individual members. Toward this end, the staff has increased monitoring of trade developments and made greater contacts with national trade officials. On recent occasions, one or more members of an Article IV consultation team have visited GATT headquarters in Geneva prior to or following an Article IV mission to a major trading country in order to obtain information and the informal views of GATT officials on recent trade policy developments of relevance to the country concerned. In this context, the recent establishment in the GATT of a special division that will systematically assemble available information on trade policy actions and developments on a country-by-country basis is expected to greatly facilitate the staff's contacts with GATT officials.

During the Executive Board discussion of Fund surveillance on March 12, 1984, Directors reiterated their broad support for the enhanced role of the Fund in this area in the context of Article IV consultations. The Managing Director asked the staff to include more quantification of protection. In response to these suggestions, the staff has attempted to improve further both the coverage and analysis of trade policy developments. Where relevant, measures adopted in the framework of regional arrangements are featured in the reports for individual members. The impact of trade policy on domestic adjustment, trade flows, the balance of payments, and export prospects of trading partners has been featured more frequently in consultation reports on the industrial countries. Quantified assessments of the incidence or effects of trade measures have also been included.

Examples of improved trade coverage in Article IV consultation papers include the report on the United States (SM/84/178, Supplement 1, 7/20/84) which quantified the effects of the bilateral export restraints on Japanese automobiles on prices and sales of automobiles in the United States, and a discussion of U.S. trade policy and competitiveness in the steel industry. In the United Kingdom report (SM/84/43, 2/13/84), data on import penetration, employment, and output in sectors subject to protectionist pressures were included, as well as a discussion of trends in farm support payments in the United Kingdom through the EC's Common Agricultural Policy. The report on Germany (SM/84/152, 7/3/84) featured direct and sectoral subsidies. The report on France (SM/84/123, 5/29/84) featured the Community's New Commercial Policy Instrument adopted at the initiative of the French authorities, and discussed quantitative indicators of trade policy measures. The report on Japan (SM/84/41, Supplement 1, 2/14/84) investigated empirically the impact of exchange rate changes on selected Japanese manufactures that have been subject to protectionist pressures abroad. In staff reports on most major trading nations, critical assessments of the stance of trade policy have been featured increasingly. The most comprehensive example is to be found in the staff report on the United States (SM/84/162, 7/6/84).

b. Suggestions for improvement

Possible improvements in trade policy coverage in Article IV consultations are governed by the limited availability of staff and of staff expertise on trade and the inherent complexity of reaching conclusions about the overall trade policy stance. Nevertheless, provided staff resources are available, the following further suggestions could be considered. The staff would plan to collaborate informally with GATT officials in seeking their views for developing these ideas.

(1) There might be merit in organizing periodic seminars at the Fund, at which GATT officials and other trade experts, including academics and businessmen, could be invited to discuss trade policy developments, taking into account ongoing research outside the Fund. Given the overlapping interest of the Bank in this area, the staff would endeavor to organize such discussions and seminars jointly with the Bank.

(2) More quantification of the impact of trade measures in Article IV consultations has obvious merits in bringing to Directors' attention in a more concise way the costs and benefits of protection. There are, however, considerable conceptual and practical difficulties in quantification. In order to utilize its resources most efficiently, the staff could attempt to seek out available quantified estimates prepared either by governments or outside experts on various aspects of trade policies, although such studies are often available only with a considerable lag, and are thus of somewhat limited usefulness for assessing current policy trends.

(3) On occasions when major trade policy decisions have been taken or are imminent, it may be useful for Directors to be informed of them on a more current basis than is possible if trade measures are reported only in the context of (usually annual, for the major trading nations) Article IV consultations and the Annual Report on Exchange Arrangements and Exchange Restrictions. Accordingly, the staff could, in such cases, prepare separate information notes for the Executive Directors, reporting on the trade actions of the major trading country in question. In principle, the mechanism for reporting such trade actions could be similar to that established for the Exchange Rate Information notices. If Directors supported this suggestion, the staff would prepare a brief paper for Directors' consideration, outlining the broad criteria that would be used to trigger the information notes.

(4) As far as trade policy discussions are concerned, the focus of most Article IV consultations is often on measures taken or planned since the previous Article IV consultation. In the future, it is proposed that Article IV consultation papers not only report on discussions with the authorities on current trade policy developments, but also endeavor to include a tabular summary for the major trading nations, cumulatively listing principal trade restrictive or liberalizing measures in effect or taken by the Fund member from a certain uniform date. Such a table would serve to present an overview of actions from a common base date and provide a useful basis for assessing the cumulative direction of change in the stance of trade policies. Given that many governments have agreed to standstill/rollback provisions, the proposed presentation would help in monitoring whether members have exercised restraint in resorting to restrictive trade measures.

## 2. Trade policy content of Fund programs

### a. Background

A central objective of programs implemented by Fund members and supported by the use of Fund resources is the restoration of a more viable external situation without reliance on measures such as trade and payments restrictions which may be harmful to its adjustment efforts and impede those of its trading partners. In addition to the standard performance clauses on exchange restrictions, multiple currency practices, and bilateral payments arrangements, all such programs include an undertaking by the member not to impose or intensify import restrictions for balance of payments purposes. Several recent programs have also included medium-term aims to reduce reliance on trade restrictions, thereby supporting the process of adjustment to a more efficient and outward-oriented economy. Exchange rate policy and supporting policy adjustments in fiscal, monetary, pricing, and other areas, are the crucial instruments for ensuring balance of payments viability. In many important recent instances, reduction or elimination of payments arrears has been the first priority of a Fund-supported financial program. In the presence of arrears and the attendant distortions in the country's payments regime, meaningful trade liberalization is impossible; accordingly, in such

cases, the implementation of the trade liberalization objectives of the program is based on the restoration of a more orderly payments system. Moreover, in many cases, the depth of internal and external imbalances in relation to available financing on appropriate terms has constrained import demand in the short run, while the process of supply adjustment in the tradable goods sector is allowed to take place. Once this has been achieved, the policies adopted create the conditions for improvement in the current account balance through an expansion of investment and exports, without which the growth and external objectives of a program would be mutually inconsistent.

b. Assessment

Fund programs include a standard "standstill" provision on import restrictions for balance of payments purposes. Adherence to this provision in the period under review has generally been very good. In the very few cases where trade restrictions were introduced for balance of payments purposes, performance under the program as a whole was off track. On occasion, where there have been difficulties in interpreting whether a particular measure constituted an action motivated by balance of payments or other reasons (e.g., fiscal), the matter was resolved through discussions with the relevant authorities. In such cases, careful judgment is required on whether a measure should trigger the performance criterion.

In the area of import liberalization, the staff often faces four main issues in designing an import liberalization package as part of the financial program. First, even where there is no disagreement between the staff and the authorities on the desirability of liberalization, the timing of the measures is frequently an important point for consideration. As mentioned above, in principle the question is resolved in a pragmatic manner, depending on the size of the imbalances, the pace of planned complementary policy adjustments, and an assessment of the probable balance of payments, price, and output effects of the proposed liberalization.

A second and more fundamental issue is the substance of trade liberalization in Fund programs. The general approach has been to build into a program the maximum feasible degree of openness in a country's trade regime, given its external payments constraint. Between January 1979 and August 1984, 143 stand-by and EFF programs were approved. About one half of all programs and about two thirds of the EFF programs included trade liberalization as an element in the program objectives. On a stricter criterion--viz., inclusion of a specific commitment on trade liberalization--about two fifths of all programs and one half of EFF programs included a trade liberalization element. Such specific commitments include measures such as the replacement of a positive list of permitted imports with a negative list of imports subject to authorization, abolition or phasing out of an import surcharge, and expansion of the scope of open general licensing. As might be expected, the scope of trade liberalization varied considerably among programs.

In a broad sense, the effectiveness of Fund programs in endorsing and supporting trade liberalization depends on factors such as the following: (1) whether the authorities had embarked on market-opening measures prior to Fund approval of a program--in such cases, it was sometimes not considered necessary to include specific trade liberalization commitments; and (2) whether the country's external debt and financing problems were so acute as to require greater priority on exchange rate depreciation and settlement of payments arrears in order to establish the basis for future trade liberalization. In general, the Fund's approach has been to encourage the adoption of domestic and external measures that establish conditions favorable to trade liberalization over the medium term. A priority in Fund programs has been to restore the degree of openness in the restrictive system that existed prior to the emergence of the member's balance of payments problem.

Third, as to the nature of the specific liberalization measures, such as the nontariff or tariff measures to be liberalized, and in which sequence, and the sector and commodity coverage of proposed liberalization, the staff is generally guided by the objectives of the authorities and the implications of proposed changes for the fiscal objectives of the program. It relies, whenever possible, on available studies of nominal and effective protection (particularly those prepared by the World Bank, if available), and refrains from establishing the priorities for liberalization as between different sectors. This approach is consistent with the Fund's general policy of avoiding a detailed specification of a country's objectives at the sectoral or micro level.

A final issue that frequently arises is whether the trade liberalization objectives included in the program should be specified in the form of performance criteria that would enable an objective monitoring of the progress made. In general, the approach has been conservative. Of the 143 programs approved by the Executive Board since 1979, 23 programs (16 percent of all programs, and about two fifths of programs with specific trade liberalization commitments) included performance criteria relating specifically to trade liberalization. A constraint on the use of performance criteria relating to trade liberalization is the difficulty of meaningful quantification of the stance of trade policy, particularly because of many countries' extensive reliance on nontariff measures.

In the area of export subsidies, the Fund's approach is guided by considerations similar to those relating to the pace and extent of import liberalization. In many cases, an appropriate exchange rate policy will obviate the need for export subsidies. More broadly, since export subsidies are often made necessary by the existing system of import restrictions, a program of import liberalization undertaken in connection with a broad adjustment program involving the exchange rate policy should similarly make it possible to eliminate--or at least reduce--the scope of export subsidies. Of the 143 programs approved, 14 included binding or nonbinding commitments regarding export subsidies and/or export taxes.

Compliance with both binding and nonbinding commitments regarding trade liberalization has been generally high; over three fourths of the commitments have been fully or partially implemented. It is difficult, however, to attempt a substantive judgment on whether trade liberalization encouraged by Fund programs has involved a lasting shift in the openness of markets.

### 3. Fund-GATT collaboration

Since the last comprehensive review of trade policy developments by the Executive Board in September 1982, informal collaboration and contacts between the Fund and the GATT have been intensified. The contacts with the GATT secretariat in the context of the Fund's Article IV consultations were referred to earlier. Fund staff members (usually from the Office in Geneva) observe the great majority of meetings of GATT bodies that are held throughout the year, including the GATT Council and specialized GATT committees dealing with areas such as subsidies, textiles, trade and development, agriculture, etc. The Managing Director addressed the November 1982 GATT Ministerial meeting in Geneva, and has subsequently been in close contact with the Director-General of the GATT. He also attended the meeting of trade ministers organized by U.S. Trade Representative Brock in Washington in May 1984. Senior Fund staff and GATT officials are in regular contact on matters of mutual concern. As a result of this collaboration, a better mutual understanding has developed between the two institutions on a wide range of issues relating to their objectives and policies. The staff believes that these contacts and informal cooperation should be continued and reinforced, given the Fund's vital interest in a liberal, multilateral world trading system.

The focal point of Fund-GATT collaboration continues to be the effective implementation of the provisions relating to trade actions for balance of payments purposes taken by common members. Article XV of the General Agreement provides the broad framework for GATT consultations in the Committee on Balance of Payments Restrictions.<sup>1/</sup> These consultations focus on the balance of payments justification for trade measures. Their scope has been broadened somewhat in the past two years. First, for the first time since the adoption of the 1979 Declaration on Trade Measures, two countries (Brazil in December 1983, and Korea in October 1984) have drawn the Committee's attention to their problems of market access abroad, and have requested their major trading partners in the Committee on Balance of Payments Restrictions to give sympathetic consideration to them when formulating their trade policies. It is suggested that, in future cases where the Fund is aware of significant

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<sup>1/</sup> GATT Article XV:1 stipulates: "The CONTRACTING PARTIES shall seek co-operation with the International Monetary Fund to the end that the CONTRACTING PARTIES and the Fund may pursue a co-ordinated policy with regard to exchange questions within the jurisdiction of the Fund and questions of quantitative restrictions and other trade measures within the jurisdiction of the CONTRACTING PARTIES."

problems of market access abroad, the Fund statement on a consulting country should include Fund support for trade liberalization in support of that country's case before the GATT. Such a statement was included, for the first time, in the Fund statement to the GATT on Korea.

Second, consultations on restrictions imposed for balance of payments reasons have been held with 16 contracting parties in the past two years; with 2 of them, the consultations were held for the first time. The frequency of meetings of the Committee on Balance of Payments Restrictions has increased from about twice a year in 1981-82 to three or four times a year in 1983-84. The Fund staff is in close contact with the GATT secretariat regarding the timing of balance of payments consultations. In accordance with the views expressed by Executive Directors when considering the Fund statement on Israel, 1/ the Fund staff will continue to encourage the GATT secretariat to arrange scheduling in a manner that is most conducive to enhancing the effectiveness of the GATT consultation process. This will require, in practice, that GATT consultations be scheduled taking into account, to the extent possible, the timing of Article IV consultation discussions in the Fund's Executive Board.

In addition to the specific and general areas of Fund-GATT collaboration outlined above, issues of special Fund concern, such as the exchange rate system, are brought up by contracting parties in relation to their implications for the trading system. At the November 1982 GATT Ministerial meeting, the CONTRACTING PARTIES requested the GATT's Director-General to consult with the Managing Director of the Fund on the issue of the effects of exchange rate fluctuations on international trade. In response, the Fund staff prepared a study in 1983 entitled "Exchange Rate Volatility and World Trade" (SM/83/203, Rev. 1, 12/9/83) for transmittal to the GATT CONTRACTING PARTIES. 2/

At their 40th session in November 1984, the GATT CONTRACTING PARTIES adopted a decision on exchange rate fluctuations and their effect on trade. The decision noted that exchange market instability may increase protectionist pressures, but problems of market uncertainty for traders and investors cannot be remedied by protective trade action. They also recognized that adjustment to uncertainty could be more difficult for small traders, small trading countries, and developing countries. The decision continued that:

The CONTRACTING PARTIES therefore urge that their concern regarding the relationship between exchange market instability and international trade be taken into account in ongoing efforts within the International Monetary Fund to review the operation of the international monetary system with a view to possible improvements.

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1/ EBM/84/78 (5/16/84).

2/ This paper was subsequently published as IMF Occasional Paper No. 28, cited above.

Recently, at the initiative of the Director-General of the GATT, the Fund staff and the GATT secretariat have been in contact in order to determine how information on services and on restrictions on service flows available in the Fund could best be made available to the GATT in connection with its work in the area of services.

The staff believes that the arrangements for close Fund-GATT collaboration that have evolved over the years have worked well, given the distinct institutional and decision-making processes governing them, and that such cooperation should continue to be enhanced.

#### V. Issues for Discussion

In order to assist in the discussions, the staff has drawn together a brief list of the policy issues that merit governments' attention.

1. What attitudes do members take on the desirability and feasibility of accelerated trade liberalization?

The central policy issue that emerges from the staff survey is how to accelerate the dismantling of trade restrictions--especially nontariff barriers--to aid the economic recovery and improve the adjustment process. Global trade liberalization based on a possible new round of trade negotiations under GATT auspices may not bring results for several years. If governments wish to accelerate trade liberalization, which avenues are likely to be most promising? What specific actions would be required by governments and international institutions to encourage early actions?

2. How do members assess the shift in policymakers' attitudes toward bilateral approaches to trade policy formulation, and the risks this poses for multilateral trade discipline?

Major trading nations now appear less willing to base trade policies on multilateralism as the sine qua non for balanced trade expansion. Although the benefits of multilateralism are broadly recognized, in some quarters it is increasingly viewed as an adjunct to bilateral and plurilateral approaches. How significant is this shift, and what would be its implications for smaller trading nations, both developed and developing? How can the central trade policy problem--the proliferation of nontariff barriers--be dealt with through bilateral approaches, without triggering generalized and widespread discrimination in international trade?

3. What are the prospects for an international standstill and rollback of protection?

A central issue is how to effectively strengthen international surveillance of trade policy developments to minimize the possibility of a further drift toward protectionism in the period until more effective and permanent mechanisms are agreed internationally. Although the initiation of a new trade round by itself tends to act as a brake on

protectionist actions, governments may consider this as an inadequate guarantee that a standstill will be effectively observed, particularly in sectors where bilateral and discriminatory measures have proliferated. A related question is whether it is desirable to strengthen existing international pledges to avoid protectionism and possibly include in them a degree of commitment for future liberalization of restrictions with an expiration date that is known in advance.

4. Should actions by industrial countries to liberalize trade in favor of developing countries be emphasized?

A closely related point is whether governments would be prepared to undertake early, specific trade liberalization actions in order to contribute to the balance of payments adjustment and growth prospects of developing countries. In the past few years, several developing countries have implemented strong adjustment programs to bring their current account deficits in line with available financing prospects. Some Fund members have also embarked on trade liberalization programs as part of a comprehensive adjustment strategy. In order to establish a sound basis for efficient export expansion over the medium to long term, early trade liberalization by industrial countries in sectors of actual or potential export interest to developing countries would appear to be desirable. It would be a way to encourage debtor countries in their trade liberalization actions and would constitute a "positive sum" game. Eliminating existing bilateral restrictions would also strengthen multilateralism in trade. Thus, an important issue is what measures can be taken by industrial countries in the near future to encourage progressively greater integration with the developing countries' economies.

5. What is the scope for unilateral trade liberalization?

Some industrial and developing countries have taken steps in recent years to implement policies to open their markets to international competition without awaiting the launching of global trade negotiations. Although the mutually interactive trade liberalization process through exchange of trade concessions in the GATT has made an outstanding contribution to an open, multilateral trade system, a crucial policy question is whether these multilateral mechanisms for liberalization can be supplemented by further unilateral trade liberalization measures based on the most-favored-nation principle.

6. What is the desirable and feasible pace of simplification and liberalization of trade regimes by developing countries?

Notwithstanding the notable progress in trade liberalization in some countries, there is clearly considerable scope for further moves toward more open trading systems in most developing countries. In countries with complex, longstanding restrictions, the priority may be the simplification of trade regimes, particularly lowering tariff dispersion and reducing reliance on quantitative restrictions. In other

cases where substantial progress toward liberalization has already been made in some sectors, the priority would be to expose more sectors to international competition, and to broaden the scope of more open trade policies to import-competing sectors. Prior announcement of the trade liberalization schedule may provide additional assurance of developing countries' medium-term policy intentions. Through flexible international monitoring mechanisms such as those in the GATT, developing countries could provide greater assurance to their trading partners that their own trade liberalization process will not be reversed after a short period, or that any setbacks to the liberalization process will be limited in scope.

