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*The GATT, Quantitative Restrictions, and  
the Balance of Payments*

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**THE GATT, QUANTITATIVE RESTRICTIONS, AND  
THE BALANCE OF PAYMENTS**

by

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## Abstract

A major objective of the Uruguay Round of trade negotiations is the reduction and elimination of quantitative restrictions on trade. The developed countries expect such liberalization on their part to be matched by reciprocal action not only by other developed countries but by the newly industrializing countries as well. However, the newly industrializing countries invoke the broad GATT balance of payments exception as the basis for a wide range of quantitative import restrictions that are clearly protective of individual industries and sectors. The paper argues that the justification for this exception to the general GATT prohibition of quantitative restrictions was of doubtful validity at the GATT's inception. The exception is even more anachronistic today when countries enjoy an additional degree of freedom in adjusting their payments position through changes in exchange rates. Unless countries relinquish their right to reimpose quantitative restrictions for balance of payments reasons, the basis for a negotiation to liberalize quantitative restrictions does not exist.

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# The GATT, Quantitative Restrictions, and the Balance of Payments

by Isaiah Frank

## I. Introduction

Among the objectives of the Uruguay Round of multilateral trade negotiations, three are paramount: to liberalize trade, especially by reducing or eliminating quantitative restrictions; to strengthen existing rules such as those on safeguards and subsidies; and to update the General Agreement on Tariffs and Trade (GATT) by taking account of new developments affecting the world trading systems such as the growth of trade in services and the increasing importance of the protection of intellectual property.

Under all three of these headings -- liberalization, strengthening, and updating -- a long-neglected subject cries out for attention. That subject is the exception for balance of payments reasons to the general GATT prohibition of the use of quantitative restrictions (QRs). Resort to this exception has impeded the liberalization of trade and has undermined the integrity of the GATT system. Moreover, whatever the original justification for the provision, it has clearly become anachronistic under a regime of flexible exchange rates.

The purpose of this paper is to: examine the rationale for the present GATT rules on QRs; convey an indication of the extent of resort to the balance of payments exception to the rules; evaluate the roles of the GATT and the International Monetary Fund (IMF) in monitoring the exception; assess the appropriateness of the exception under present circumstances; and propose a way of dealing with the problem in the context of the current multilateral trade negotiations.

## II. Rationale for Present Rules

Tariffs and QRs are not treated in the GATT simply as two alternative methods of trade protection. If a country wishes to protect its domestic industry, a tariff is the preferred way to do so. A country is free to impose or raise a tariff on any product provided it has not specifically agreed to refrain from doing so. On the other hand, the use of QRs is prohibited except under carefully specified conditions.

### A. Tariffs versus Quotas

The distinction in the treatment of these two forms of protection is well founded. Tariffs are a flexible instrument: they permit imports to grow as costs and prices decline abroad and income and demand rise at home. By contrast, QRs impose rigid limits on the volume of trade. Tariffs allow trade to shift among countries in accordance with comparative advantage whereas QRs tend to freeze trade into established channels. Tariffs generally apply equally to all foreign countries whereas import quotas are likely to be discriminatory in purpose and effect. The degree of protection is overtly defined by the rate of duty whereas it is hidden when QRs are used. A final distinction of economic importance concerns the distribution of the excess of the price in the sheltered market over the world price. In the case of import duties, the excess goes to the public treasury in the form of import duty receipts whereas, in the case of quotas, the excess generally accrues as a windfall to either the foreign exporters or the domestic importers to whom the quotas are allotted.

Beyond the economic advantages of tariffs over quotas, other considerations dictated the tight limitations in the GATT on the use of QRs. Quotas inevitably involve the regulation of domestic business by public offi-

cials. Because of the great power inherent in the setting and allocation of quotas, they involve a dangerous temptation to official corruption. On the other hand, legislatures have, for historical reasons, been reluctant to surrender their authority over tariffs to administrative officials.

The limitation on the use of quotas was also necessary in the context of other provisions of the GATT and of the Articles of Agreement of the IMF. If tariff concessions negotiated in the GATT were not to be nullified, a country's freedom to impose quotas had to be constrained. Similarly, if the IMF rules on the use of exchange restrictions were not to be evaded, a limitation had to be placed on the use of quotas which could serve as substitutes for exchange controls.

B. Exceptions to the Prohibition of QRs

Although a number of exceptions to the outright prohibition of quotas are included in the GATT, many of them are technical or transitory in nature. The two most important and enduring exceptions are those for agriculture and the balance of payments.

The exception for agriculture is required by domestic programs which support the price of agricultural products by restricting the amounts that may be produced or sold in the home market. Unless imports are controlled, an expansion of foreign supplies would offset the contraction of domestic output. Prices would be held down and the program would fail to achieve its objective. Thus, the logic of the provision is impeccable although, in practice, agricultural protection has far transcended over the years the limits permitted by this exception.

The other major exception to the no-QR rule -- the balance of payments exception -- consists of a set of lengthy, complex, and rather opaque

provisions scattered over a number of the GATT articles (Articles XII-XV and XVIII). The provisions are of three types: the criteria for invoking the exception; the obligations applying to the use of QRs under the exception; and procedural rules relating to review and consultation.

No useful purpose would be served by attempting to recount the detailed articles. But a brief summary is essential. The basic provision is that QRs may be used to safeguard a country's "external financial position and its balance of payments" but only to the extent necessary "(i) to forestall the imminent threat of, or to stop, a serious decline in its monetary reserves, or (ii) in the case of a country with very low monetary reserves, to achieve a reasonable rate of increase in its reserves." 1/ Determinations as to the adequacy of reserves are left to the IMF.

However, the right to impose QRs for balance of payments reasons is not unlimited. Countries are obliged to relax the restrictions as conditions permit. Moreover, the restrictions must be applied on a nondiscriminatory basis. As QRs are readily open to discrimination in their administration, the GATT calls upon countries, in applying such restrictions on any product, "to aim at a distribution of trade in such product approaching as closely as possible the shares which the various contracting parties might be expected to obtain in the absence of such restrictions." 2/

Adding to the complexity of the rules is an exception to the non-discrimination principle in the application of QRs for balance of payments reasons. A country may deviate from this principle "in a manner having

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1/ GATT Article XII:1 and 2.

2/ GATT Article XIII:2.

equivalent effect to restrictions on payments and transfers for current international transactions" 3/ which it is permitted to apply under Articles VIII or XIV of the Articles of Agreement of the IMF.

The upshot is that the IMF is assigned an important role in monitoring the use of QRs for balance of payments purposes. First, it is given the authority to determine the facts as to a country's level of reserves. Second, it has the responsibility to determine whether the facts meet the rather imprecise legal standards of "serious decline", "very low" levels, and "reasonable rate of increase" in a country's reserves. Finally, IMF determinations with respect to the adoption or intensification of exchange restrictions affect the right of GATT contracting parties to apply QRs in a discriminatory manner.

Developing countries have recourse under GATT Article XVIII, Section B to essentially the same balance of payments exception for the use of QRs that applies to contracting parties generally under Article XII. The main difference is the less stringent procedural rules of Article XVIII. For example, consultations are required annually for QRs imposed under Article XII but only every other year under Article XVIII.

The focus of the balance of payments exception on the adequacy of a country's reserve position suggests that the provision is predicated on the existence of a par value exchange rate system. Under such a system, an adequate level of reserves is needed to defend the fixed parity without resorting to severe deflationary measures that could result in an abrupt contraction of employment and economic activity. If, however, the level of

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3/ GATT Article XIV:1.

reserves is low or falling, a second line of defense of the exchange rate is the reduction of imports through trade restrictions. The idea that a less expansionary macroeconomic policy might render unnecessary the resort to trade restrictions is specifically rejected in GATT Article XII. 4/

True, the need for reserves may not have been greatly reduced with the adoption of a system of floating exchange rates. Under a managed float, countries continue to hold reserves for intervention in the exchange markets, as a precaution against unanticipated disturbances, and as a demonstration of creditworthiness. As a means of defending reserve positions, however, countries possess today an alternative to import restrictions in their freedom to let the exchange rate move.

Even if a temporary reduction of imports is deemed necessary to deal with a balance of payments problem, it remains something of a mystery as to why it should take the form of QRs rather than tariffs. One possible justification under the Bretton Woods exchange rate system might be the need for speed in a situation where a country was rapidly losing reserves. But this was precisely the explanation given by the United Kingdom in 1964 for avoiding the use of QRs and adopting instead a tariff surcharge to defend its payments position even though the surcharge was unauthorized by the GATT. In its notification to the GATT, the UK stated that reduction in its balance of

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4/ GATT Article XII:3(d): "The contracting parties recognize that, as a result of domestic policies directed towards the achievement and maintenance of full and productive employment or towards the development of economic resources, a contracting party may experience a high level of demand for imports involving a threat to its monetary reserves... Accordingly, a contracting party...shall not be required to withdraw or modify restrictions on the ground that a change in those policies could render unnecessary restrictions which it is applying under this Article."

payments deficit "required urgent action which would only have been delayed while the elaborate administrative machinery of import licensing was re-established and licenses were allocated to importers." 5/

Similarly, when the US adopted an import surcharge in 1971, it stressed the need "to provide relatively quick benefits to its trade balance" until the problem could be adequately dealt with in other ways. 6/ Thus, the need for speed in defending the balance of payments through trade measures would appear to argue in favor of uniform tariff action rather than inherently selective and discriminatory quantitative restrictions that inevitably carry a heavy administrative load.

An alternative justification for import quotas in cases of balance of payments difficulties is the desire to concentrate the import restriction on luxury goods so that scarce foreign exchange would be conserved for imports of more essential products. 7/ However, the effect of such a restriction is to encourage the domestic production of noncompetitive luxury goods and the increased importation of raw materials and intermediate products to support that production. If the intent is to reduce the consumption of luxury goods without diverting fungible domestic resources to their production at home, the preferred method would be a tax on the consumption of luxuries regardless of

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5/ Jackson, John, World Trade and the Law of GATT, the Bobbs-Merrill Co., New York, 1969, p. 713.

6/ GATT, Basic Instruments and Selected Documents, Eighteenth Supplement, Geneva, April 1972, p. 214.

7/ GATT Article XII:3(b) states: "Contracting parties applying restrictions under this Article may determine the incidence of the restrictions on imports of different products or classes of products in such a way as to give priority to the importation of those products that are more essential."

whether they are produced at home or abroad. In short, it is difficult to find a defensible rationale for the specification of quantitative restrictions as the preferred trade measure to counter temporary balance of payments problems.

### III. Resort to Balance of Payments Exception

So far as can be ascertained, no industrial country has invoked balance of payments reasons for quantitative restrictions imposed in recent years. When a balance of payments justification has been given for trade restrictions, the action has generally taken the form of tariffs, and the latter in turn have been in the form of across-the-board surcharges rather than selective tariffs that protect particular categories of goods.

Developing countries, however, have resorted extensively to quantitative restrictions for balance of payments reasons. For example, Brazil notified the GATT that in 1983 it had in effect 361 quantitative restrictions, the justification for which, according to the IMF, was "balance of payments reasons related to the process of development." The same justification was given for 442 QRs by Ghana, 122 by India, 253 by Korea, 330 by Nigeria, 434 by Pakistan, 492 by Tunisia, and lesser numbers by other developing countries. 8/

Actually, the use of QRs by developing countries for balance of payments reasons may be presumed to be far more extensive than indicated by those self-notifications to the GATT. The IMF table, from which the above data were taken, showed no notifications for many developing countries

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8/ Shailendra Anjaria, Naheed Kirmani, and Arne Petersen, Trade Policy Issues and Developments, IMF Occasional Paper No. 38, 1985, Table 7, pp. 104-105.

including, for example, Argentina and Colombia, countries which are known to have had wide-ranging systems of import controls.

A point worth noting is that the formal distinction between import restrictions imposed for economic development and for balance of payments reasons has become virtually totally blurred in practice. This result is inevitable because of the way the link between the two is made in GATT Article XVIII:2 which permits developing countries "to apply quantitative restrictions for balance of payments purposes in a manner which takes full account of the continued high level of demand for imports likely to be generated by their programs of economic development." In effect, this formulation allows any developing country with a program of development to claim a balance of payments justification for quantitative import restrictions.

#### IV. Roles of the GATT and the IMF

Neither the GATT nor the IMF has in practice been in a position to prevent the extensive use of balance of payments QRs by many developing countries. Although contracting parties are supposed to notify the GATT of their QRs and the justification for them, some, as already indicated, simply do not bother to do so whereas others do so incompletely or imprecisely. Moreover, the consultations required under the GATT have proven ineffective in practice.

As noted, a developing country imposing balance of payments restrictions is required under Article XVIII to consult every other year as to the nature of its payments difficulties, possible alternative corrective measures, and the effect of the restrictions on other countries. In addition to a basic paper submitted by a consulting country, documentation for a "full

consultation" includes a detailed statement by the IMF on the financial position of the country and a paper drafted by the GATT secretariat on the trade aspects of the measures taken. At the conclusion of a full consultation, the Committee on Balance of Payments Restrictions adopts a report summarizing its views on the nature of the payments problem, its relation to trade imbalances, other measures adopted to correct the problem, and plans to phase out the restrictions. Since the move to flexible exchange rates in 1973, the conclusions do not specifically address the justification for the restrictions as a means of avoiding a decline in a country's reserves. The reports are circulated to all contracting parties and are generally approved by the GATT Council without further discussion.

In 1972, however, a decision on "simplified consultations" was adopted for developing countries. Under this procedure, there is no IMF statement and no substantive conclusions by the Committee but only a statement to the effect that the examination was carried out and that the country imposing the restrictions has therefore complied with its obligations. In recent years the great majority of consultations that have taken place have been under the simplified procedure. Even full consultations comprise a rather formalistic exercise without serious follow-up, but the simplified consultations are totally lacking in any bite in terms of disciplining the behavior of countries invoking the balance of payments exception for QRs.

Although the IMF's role in monitoring QRs may be viewed as ancillary to that of the GATT, it is the chosen instrument for restraining the use of exchange restrictions. Unlike QRs, which are always protective, exchange controls may or may not be. For example, a heavily indebted country may apply exchange restrictions to limit the current servicing of a loan, perhaps for

the purpose of forcing refinancing or rescheduling. This type of restriction has no protective effect. To the extent that exchange restrictions limit the allocation of foreign exchange for the import of particular types of goods, however, the restrictions are the functional equivalent of QRs.

Most developing countries have availed themselves of the right under IMF Article XIV to maintain the exchange restrictions on current transactions that were in effect at the time they became members of the IMF. But the IMF does require that any new restrictions or intensification of existing ones be subject to its approval. The IMF's close scrutiny of exchange restrictions may well have had the unintended effect of pushing countries contemplating new or intensified restrictions toward the use of trade measures such as QRs where the international surveillance procedures are much looser.

It should be noted, however, that the IMF does exert some influence on QRs in conjunction with two of its regular activities. When exercising surveillance over members' exchange rates in accordance with Article IV of the Articles of Agreement, the IMF judges the appropriateness of a rate partly by the extent of resort by the member to new or intensified restrictions on trade or capital flows. It seeks to encourage exchange rate changes that would obviate the need for the controls. In addition, when applying conditionality on IMF drawings, the IMF requires as a minimum a standstill on both trade restrictions for balance of payments purposes and exchange controls while trying to push countries toward liberalization.

#### V. Assessment

The best that can be said for the present complex system of oversight of balance of payments QRs is that it may exert some marginal restraint on

their use. However, the continuing and widespread resort to such QRs is evidence of a basic flaw in the system that cannot be remedied through procedural changes. The flaw is the sanctioning in the GATT of micro measures to deal with macro problems. In theory, this mismatch could best be fixed by revising the GATT to outlaw patently protective measures, such as QRs, as a means of dealing with a country's unsustainable excess of total expenditure over output.

It is now generally accepted that balance of payments adjustment requires some combination of demand restraint, supply-side measures to increase output, and exchange rate changes and other reforms to shift the pattern of output toward net exports. The reforms typically included in adjustment programs sponsored by the World Bank and the IMF comprehend among supply-side measures reductions in protection based on the well-recognized principle that a tax on imports is a tax on exports. In the light of this emphasis, it is anomalous to preserve in the GATT the right to impose increases in protection in the form of QRs to cope with balance of payments problems. The anomaly is particularly acute in a world of flexible exchange rates that provide an additional degree of freedom in adjusting the balance of payments that was absent when the GATT was negotiated.

Even if temporary protection were justified as an emergency measure pending the adoption of more basic reforms, QRs would be the least desirable form of protection. As explained at the outset, they are rigid and inherently discriminatory; they provide windfalls to importers or exporters rather than revenues to the government; and they enhance the power of bureaucracies that must administer the quotas. From all these perspectives tariffs would be a superior way of providing temporary protection. And, in the case of tariffs,

the distortive effect of protection on the sectoral allocation of resources can be reduced by minimizing the dispersion of tariff rates among different products.

Two dangers lurk in the continued legitimization in the GATT of QRs for balance of payments purposes. The first is that developed countries, that have for many years abstained from invoking this exception to the no-QR rule, may now find it convenient to do so. In 1986 the US House of Representatives passed an omnibus trade bill that, if enacted into law, would have given the President authority to impose import restrictions, including quotas, against any country with "excessive" surpluses in its trade with the United States. Although the bill made no reference to the GATT balance of payments articles, it could have been claimed to be in the spirit of those provisions. If the massive US trade deficit persists, the pressures to deal with it through GATT-sanctioned protectionist devices will intensify.

The second danger is equally disturbing. A major objective of the newly launched Uruguay Round is "the reduction and elimination of tariffs, quantitative restrictions and other non-tariff measures and obstacles." <sup>9/</sup> The politically difficult decisions required in the developed countries to resist protectionist pressures, and reduce or dismantle their textile and other quantitative restrictions, would be possible only in the context of a serious reciprocal commitment by the newly industrializing countries (NICs) to curtail and eliminate their own restrictions. However, the developed countries recognize that any trade liberalizing action by the NICs, whether in the form of tariff reductions or quota eliminations, is of doubtful value if

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<sup>9/</sup> GATT, Ministerial Declaration on the Uruguay Round, September 20, 1986.

the NICs can continue to take advantage of the wide-open dispensation in Articles XII and XVIII to impose QRs for balance of payments reasons. Without some alteration of this situation, the negotiation is unlikely to succeed and, if it did, the resulting liberalization on both sides is likely to be short-lived.

#### VI. Conclusions and Recommendations

Neither the principle nor the practice of the use of QRs for balance of payments reasons has been seriously examined in the almost forty years of GATT's existence. But experience over that period has unequivocally demonstrated the essentially protective nature of such restrictions. The most telling evidence is that in the vast majority of cases the QRs have been applied to highly selective groups of products rather than across-the-board. We should, therefore, recognize them for what they are -- namely, a subterfuge for protection. The cleanest way to deal with the problem would be to revise the GATT so as to eliminate the right to impose QRs for balance of payments reasons.

Although in theory the Uruguay Round provides an opportunity for strengthening the GATT by modernizing its provisions, it is unlikely that agreement could be reached even to include on the agenda the subject of revising the provisions on balance of payments restrictions. A more promising approach, therefore, would be through a self-denying joint declaration by the developed countries to which the NICs and any other developing countries would be invited to subscribe.

The substance of the declaration would consist of three parts.

- (i) The recognition that balance of payments difficulties reflect primarily macroeconomic problems for which the remedies lie largely in adjustments in fiscal, monetary, and exchange rate policies.
- (ii) A commitment to avoid the use of balance of payments QRs because they are inherently selective and rigid and therefore impede the very types of resource reallocations that are required to promote adjustment.
- (iii) A declaration that, if temporary trade restrictions are deemed to be necessary elements of a broader adjustment package, they should take the form of across-the-board import surcharges rather than QRs.  
(Although surcharges are not specifically permitted under the GATT articles, the Framework Agreement adopted in the Tokyo Round implicitly endorses their use as a less restrictive alternative to balance of payments QRs.)

If the developed countries and the NICs subscribed jointly to a declaration along the foregoing lines, a major obstacle would be removed to the negotiation of reciprocal reductions of QRs among the members of the GATT. Although the Uruguay Declaration calls for a unilateral rollback of trade restrictive measures, the commitment is limited to "measures inconsistent with the provisions of GATT or instruments negotiated within the framework of GATT or under its auspices". 10/

The qualifier in the rollback commitment is clearly meant to exempt the vast bulk of existing QRs including especially those adopted by the

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10/ GATT, Ministerial Declaration on the Uruguay Round, September 20, 1986.

developed countries pursuant to the Multi-Fibre Arrangement and those justified by developing countries under the GATT balance of payments provisions. Also exempt from the rollback would be lesser numbers of QRs justified under other provisions including those pertaining to economic development, agriculture, and to restrictions necessary to the application of standards and regulations in international commodity trade. The unilateral phase-out would therefore apply primarily to QRs and "grey-area" measures, such as voluntary export restraints, that should have been applied under the Article XIX escape clause but that have circumvented that provision because of their discriminatory character or because of the desire to avoid the need to provide "compensation".

In addition to the unilateral phase-out, however, the Uruguay Declaration calls for negotiations "to reduce or eliminate non-tariff measures, including quantitative restrictions, without prejudice to any action to be taken in fulfillment of the rollback commitments." Such negotiations will center on "legal" QRs -- that is, primarily the textile and clothing restrictions of the developed countries and the balance of payments QRs of the developing countries. Success in those negotiations can only be achieved, however, if the parties commit themselves not to reimpose the restrictions, a commitment analogous to the understanding in tariff negotiations that, once duties are reduced, they are bound against unilateral increase. To the extent that countries subscribe to the proposed declaration on balance of payments QRs, this assurance would be substantially provided.

Of course, all countries -- developed and developing -- would, as in the case of tariffs, retain whatever other rights to protective measures are stipulated in the GATT including temporary infant industry protection for

developing countries and Article XIX safeguards for all contracting parties. Insofar as the infant industry exception is concerned, it has been subject to firmer GATT discipline than the balance of payments provisions, and has therefore been invoked much less frequently as a justification for restrictions. With respect to safeguards, the Uruguay Declaration acknowledges the need for a more effective discipline and calls for a new "comprehensive agreement" on the subject. To the extent that a strengthened safeguard code is adopted, an additional bulwark will have been built against the reversal of the liberalization of QRs.

In short, the combination of a more effective safeguard code plus a joint declaration by the industrial countries and the NICs to abstain from resort to QRs for balance of payments reasons are essential conditions for serious negotiations for the reduction or elimination of quantitative restrictions in international trade.

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