

GENERAL AGREEMENT ON TARIFFS AND TRADE

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WORKING PARTY ON SPECIFIC DUTIES

Note by the Secretariat

At the request of the Working Party, the following note by the secretariat summarizing the discussion held at the second meeting of the Working Party on 9 October 1978 is circulated. Some delegations reserved their position on various points discussed by the Working Party.

I. Is it in principle desirable that Article II:6(a) should apply under a system of flexible exchange rates?

1. One delegation said that there were considerable obstacles to the implementation of Article II:6(a) under present monetary circumstances. Exchange rates were moving for many reasons, and situations were conceivable in which the adjustment of specific duties in accordance with the principles of Article II:6(a) was not necessary to maintain, or would even increase, the ad valorem incidence of such duties. The Article appeared to be designed to permit adjustments required to offset the inflationary erosion of specific duties, but exchange rate changes did not always fully reflect the inflationary erosion of currencies. Moreover, while the par value changes referred to Article II:6(a) could be easily calculated, the measurement of exchange rate movements under a system of floating exchange rates presented difficulties. For these reasons it was uncertain to what extent Article II:6(a) could or should be maintained as an operative provision of the General Agreement. It would in any case not be desirable to establish a set of rules for specific duty adjustments that would apply indiscriminately to all cases. General guidelines, on the basis of which each individual case would be examined, should be established instead.

2. One delegation stated that the right to make specific duty adjustments under flexible exchange rates could not be challenged. One of the purposes of Article II:6(a) was to encourage the binding of specific duties by permitting their adjustment in response to unexpected monetary disturbances. This rationale applied both under fixed and flexible exchange rates.

3. Several delegations believed that the question of the desirability of a continued application of Article II:6(a) could only be answered once the following questions had been examined.

II. How can the purpose of Article II:6(a) be achieved in the present monetary circumstances?

4. One delegation suggested that the following conditions should be met before the CONTRACTING PARTIES approved specific duty adjustments in present monetary circumstances:

- (a) The adjustment should not lead to a net increase in the level of protection.
- (b) The IMF should be consulted regarding the consistency of the exchange rate movement with the amended Article IV of the Fund Agreement.

- (c) The exchange rate movement should be measured in terms of an index of effective exchange rates weighted by shares of imports subject to specific duties.
- (d) Temporary and reversible depreciations should not be taken into account. Adjustments should therefore be cancelled if a sharp appreciation immediately followed the depreciation.

5. Another delegation stated that the basic purpose of Article II:6(a) was to permit adjustments offsetting the inflationary erosion of specific duties. This purpose could, however, not be achieved if the right to adjust specific duties was only linked to the average depreciation of a currency in terms of other currencies, since a depreciation so measured tended to reflect only the difference between the domestic and the average foreign inflation. Adjustments in accordance with exchange rate movements therefore tended to be incomplete.

6. The same delegation cautioned against the adoption of rigid adjustment rules that might no longer be adequate if monetary circumstances changed. In this context this delegation stressed that a return to a less flexible exchange rate system could not be excluded. It might therefore be preferable to leave the choice of the modalities of adjustment to the discretion of each individual contracting party subject of course to the approval of the CONTRACTING PARTIES. The delegation indicated however its readiness to discuss general guidelines on the basis of which specific duty adjustments should be made in present monetary circumstances.

III. How is the depreciation of a currency to be measured under a flexible exchange rate system?

7. The IMF representative pointed out that Fund members applied different exchange arrangements. Some members had floating currencies, others pegged their currency to another currency, or to a basket of currencies selected by the member, or to an international unit of account such as the SDR. One question for the Working Party to decide was whether there should be a uniform method of measurement or whether changes in exchange rates could be measured in terms of the different systems applied by different countries. If the Working Party decided that a uniform method should apply to all contracting parties, essentially three options were available. The exchange rate change could be measured in terms of:

- (a) an international unit of account, such as the SDR;
- (b) a major currency such as the dollar, or a basket of currencies;
- (c) the currencies of the trading partners of the country proposing to make the duty adjustment, appropriately weighted.

8. The Fund representative further stated that the measurement of exchange rate changes in terms of an international unit of account and one or several selected currencies had in principle the drawback that the change so determined was not necessarily proportional to its impact on trade. A correlation existed only in rather unusual circumstances, for instance, if, in the case of the measurement in terms of a major currency, the contracting party concerned traded solely with the country issuing the currency or, in the case of the measurement in terms of a basket of currencies or unit of account, if the pattern of its foreign trade corresponded exactly to the currency composition of the basket or unit. This problem could be avoided if the exchange rate changes were measured in terms of the currencies of the trading partners of the country proposing to make the duty adjustment, in other words, if an index of effective exchange rates were taken as a yardstick. If this method of measurement were chosen, the weights to be assigned to the various currencies in the calculation of the index would have to be decided upon.

9. To clarify this issue the IMF representative distributed to the members of the Working Party a paper entitled "A Note on Alternative Indices of Effective Exchange Rates" which contains the following conclusions:

"A wide range of choices is available when constructing an effective exchange rate, depending on the purpose at hand. From the point of view of assessing exchange rate movements for the purpose of adjusting specific duties, it seems clear that exchange rate changes should be measured in terms of the resulting changes on the average unit price of imports. Thus, given the objective of constructing an effective exchange rate with this purpose in mind, export-weighted, trade-weighted, or trade balance-weighted effective exchange rates need not be considered. The main choice therefore lies between (i) the import-weighted index, or (ii) a MERM-weighted index (using a MERM model suitably adjusted to express the unit value of imports as a function of exchange rates). While the MERM model is the most general, taking all induced effects into account, it should be noted first that the model at present includes industrial countries only, and second, that it is based on a large number of behavioural and statistical assumptions. On the other hand, while the import-weighted rate is also subject to a number of qualifications set forth above, from a practical viewpoint, it is generally applicable, easy to construct, and could be based on internationally-agreed data, and thus appears to be the most feasible for the purpose at hand."

10. Several representatives pointed to technical difficulties to which the use of indices of effective exchange rates could give rise. One delegation said that the basic purpose of this provision was to permit the adjustment of

specific duties whose protective effect had declined due to inflation. This purpose could however not be achieved by linking the right to make specific duty adjustments to changes in effective exchange rates because such changes tended to reflect only relative, not absolute, inflation rates.

11. Another delegation added that the impact of an overall depreciation on the unit price of a particular imported product subject to a specific duty might be quite different from the impact on the average unit price change of all imports. A duty adjustment in accordance with the average effective depreciation could therefore lead to an increase in protection in individual cases. In order to take developments in the sectors affected by specific duties into account, an index weighted by the share of imports subject to specific duties should perhaps be chosen. The IMF representative said that it would be difficult for the Fund to construct such an index as the necessary data were not readily available.

12. One delegation raised the question of how specific duties defined not in terms of the domestic currency but in terms of an international unit of account, such as the SDR or the European Unit of Account, should be dealt with. The Fund representative noted that, in the context of Article II:6(a), it would probably be relevant to compare the domestic currency equivalents of the unit of account before and after the depreciation since the protective effect of specific duties defined in terms of a unit of account depended on their domestic currency equivalents.

IV. Which is the period of exchange rate movement that should be taken into account for the purpose of measurement?

13. The secretariat informed the Working Party that in GATT practice the relevant period was the period that had elapsed since the specific duties to be adjusted were formally bound in a GATT schedule. Article II:6(a) itself referred to the period since the date of the General Agreement, that is 30 October 1947. If this provision had been applied without qualification, specific duties bound in GATT schedules after 1947 could have been adjusted on the basis of par value changes effected before the date of the binding. Thus, a duty bound at the end of the Kennedy Round could have been adjusted on the basis of exchange rate movements between 1947 and the end of this Round. In order to avoid such consequences, the legal instruments containing the results of the tariff rounds and negotiations on accessions customarily contained a clause according to which only par value changes after the date of the legal instrument could be taken into account for the purpose of adjustments under Article II:6(a).

14. It was stressed by several delegations that in the present monetary situation, which was characterized by wide exchange rate fluctuations, great care had to be taken to ensure that truly representative exchange rates were compared for the purpose of determining the size of the depreciation.

It would therefore be advisable to compare the average exchange rates prevailing over two fairly long periods of time. One delegation said that the daily average exchange rate over a ninety-day period would probably be a representative rate. So as to avoid that temporary movements were taken into account, at least one year should have elapsed between the two ninety-day periods. Exchange rate movements that occurred before the duties were bound and before the last adjustment in accordance with Article II:6(a) should not be taken into account.

15. The Fund representative said that the Fund could prepare for the Working Party's next meeting a simulation exercise showing the consequences that the choice among different exchange rate measurements, representative periods and intervals would have had in past years. The Working Party decided that it would welcome such a study. One delegate asked whether the Fund could prepare a general paper setting forth the main consequences of adopting various standards for the measurement of exchange rate changes. The Fund representative replied that he would explore this matter at headquarters.

V. What is a sufficient devaluation within the terms of Article II:6(a)?

16. The view was expressed that the required size of the depreciation of the currency should be sufficient to ensure that no cyclical or reversible exchange rate movements led to specific duty adjustments. One delegation said that the requirement of a devaluation of more than 20 per cent contained in Article II:6(a) would seem appropriate also in present monetary circumstances. Once an adjustment was made, the currency would have to depreciate again by more than 20 per cent before a further adjustment could be made.

VI. Should there be a limit on the interval which may elapse between a currency devaluation and an adjustment of specific duties?

17. The view was expressed that there should be a limit on the interval which may elapse between the depreciation and the duty adjustment. If the duties were not raised promptly after the depreciation it could be assumed that the economy had adjusted to the erosion of the protective effect of the specific duties.

18. One delegation said that Article II:6(a) did not stipulate that a contracting party could adjust its specific duties only within a certain interval after the devaluation. The effect of the erosion of specific duties could often be determined only after some time and governments therefore needed to retain their right to make adjustments.

VII. Should Article II:6(a) be symmetrical in a floating exchange rate system, that is should countries whose currencies appreciate be required to reduce their specific rates?

19. One delegation stated that if an appreciation impaired in a particular case the value of specific duty concessions the affected contracting parties could resort to Articles XXII and XXIII of the General Agreement. It was therefore not necessary for the Working Party to resolve this issue in the context of Article II:6(a). Another delegation stressed that Article II:6(a) did not provide a legal basis for the reduction of specific duties after appreciations. The same delegation noted that the appreciation of a currency could lead to lower import prices and hence an increase in the ad valorem incidence of specific duties. At the same time however the lower import prices led to greater import penetration. In this case the decline in competitiveness of the domestic industry was only partially offset by the increase in the level of protection.

VIII. If a country is permitted to adjust its specific duties because its currency depreciates, but the currency then appreciates, what action should that country take?

20. It was stressed by several delegations that the question of whether a contracting party with an appreciating currency should lower its specific duties was different from the question of whether a contracting party that had increased its specific duties after a depreciation should be obliged to cancel that increase if the value of the currency unexpectedly rose again. This aspect of appreciations had to be considered in the context of Article II:6(a).

21. One delegate pointed out that the need to provide for appreciations following depreciations might not arise if only large depreciations (i.e. 20 per cent) persisting over a fairly long period of time (i.e. one year), would entitle contracting parties to make specific duty adjustments. The representative of the Fund said that the proposed simulation exercise¹ would possibly show whether appreciations following depreciations would in fact have been a problem.

IX. What procedures should be established for the CONTRACTING PARTIES' consideration of proposed adjustments?

22. One delegation said that it was not necessary to establish a formal institutional machinery for the examination of specific duty adjustments since there had been very few cases of adjustments in the past. It was also

¹Cf. above paragraph 15.

noted that elaborate institutional mechanisms for the review of specific duty adjustments would not be necessary if a few simple rules for adjustment were agreed upon.

23. Another view was that there might be some advantage in examining proposed specific duty adjustments in a standing GATT committee rather than in ad hoc working parties. The Balance-of-Payments Committee might be the most appropriate body to deal with the matter. Examination by the Committee would be administratively convenient, ensure consistent decisions and would facilitate consultations with the IMF.

24. In response to a question the secretariat informed the Working Party that, in the past, the CONTRACTING PARTIES had generally not examined proposals for specific duty adjustments after depreciations in working parties or committees. If the requirement of a 20 per cent depreciation had been met they had in most instances given their concurrence on the condition that no individual contracting party raised objections to the proposed adjustments within a specified period of time.

X. What should be the rôle of the International Monetary Fund in the CONTRACTING PARTIES' consideration of proposed adjustments?

25. The Fund representative said that the IMF, if requested, could assist the CONTRACTING PARTIES in two ways. First, it could advise the CONTRACTING PARTIES whether an exchange rate change was consistent with the obligations of Fund members under Article IV of the Fund Agreement. In this context he pointed out that Article IV obliged Fund members inter alia to "avoid manipulating exchange rates ... to gain an unfair competitive advantage over other members". Second, the Fund could, if requested, provide the CONTRACTING PARTIES with factual information regarding the size of a depreciation.

26. The Fund representative further stated that the Fund could not advise the CONTRACTING PARTIES on exchange rate movements of currencies of non-members of the Fund and it might be necessary to make other arrangements for these cases. One delegation pointed out that the problem might be solved in the context of the general exchange obligations of contracting parties which were not members of the Fund.