

GENERAL AGREEMENT ON TARIFFS AND TRADE

RESTRICTED

Spec(79)5
18 June 1979

WORKING PARTY ON SPECIFIC DUTIES

Draft Report¹

1. At its meeting on 17 May 1978 the Council established the Working Party on Specific Duties with the following terms of reference:

"To examine the modalities for the application of Article II:6(a) in the current monetary situation, to consult with the International Monetary Fund on this matter under the provisions of Article XV:2 and to report to the Council."

2. The Working Party met on 21 June 1978, 9 October 1978, 2 May 1979 and 5 July 1979 under the chairmanship of Mr. M. Lemmel (Sweden).

3. The Working Party had available the following documents:

Spec(78)18 - Note by the secretariat listing questions which delegations proposed for consideration by the Working Party.

Spec(78)19 - Communication from the European Communities on topics suggested for examination by the Working Party.

Spec(78)32 - Note by the secretariat summarizing the discussion held at the second meeting of the Working Party on 9 October 1978.

4. A representative of the International Monetary Fund participated in all meetings of the Working Party. The Fund staff prepared at the request of the Working Party two reports entitled "A Note on Alternative Indices of Effective

¹The purpose of this draft report is to assist the Working Party in its further deliberations. It does not commit any delegation.

Exchange Rates" and "The Measurement of Changes in Exchange Rates for the Purposes of Adjustment in Specific Duties". The representative of the Fund noted that, in preparing the reports, the Fund staff had tried to cover the operationally feasible aspects of the subject. The rôle of the Fund in the activities of the Working Party was to provide technical information to the CONTRACTING PARTIES; the Fund had no mandate to participate in interpreting the General Agreement. The Fund representative emphasized in particular that it was for the CONTRACTING PARTIES to decide how the provisions of Article II:6(a) should be applied in the present circumstances. On the purely technical issue of selecting a measure for exchange rate movements, the Fund representative stated that no solution existed which would accurately reflect the effect of the exchange rate movement on the protective incidence of specific duties, would be based on readily available data, and would be uniform for all countries. In the absence of a system of measurement meeting these requirements, any solution adopted would have to balance considerations of perfection with those of convenience.

5. The Working Party noted that the rules for the adjustment of bound specific duties in Article II:6(a) of the General Agreement were drafted on the assumption that the members of the International Monetary Fund maintain par values for their currencies. However, under the present Articles of Agreement of the Fund, as amended on 1 April 1978, Fund members are no longer obliged to maintain par values but have the right to adopt exchange arrangements of their choice. Some Fund members now have floating exchange rates, and others maintain the exchange rate

against one other currency, a basket of currencies or an international unit of account. The Working Party concluded that the modalities for the application of Article II:6(a) needed to be adjusted to take into account these changes in the international monetary system.

6. The Working Party examined how the purpose of Article II:6(a) could best be achieved in the present monetary situation. Some members expressed doubts as to whether the link made in this provision between currency depreciations and specific duty adjustments should be maintained. They pointed out that the basic purpose of Article II:6(a) was to permit adjustments required to offset the inflationary erosion of the currency in which the specific duties were defined. The depreciation of the external value of a currency did however not always correspond to its inflationary erosion. The depreciation may be caused by other factors, such as a sudden capital outflow in which case a specific duty adjustment in proportion to the depreciation might lead to an increase in the level of protection; or the depreciation may stem from a difference between the domestic and the average foreign rate of inflation in which case specific duty adjustments in proportion to the depreciation would tend to be incomplete. This was likely to be the most common case in practice since inflation was widespread and differences in inflation rates were one of the major underlying causes for currency movements.

7. The Working Party noted these views but agreed that it was not its mandate to propose changes in the basic requirements of Article II:6(a) but rather to examine the ways in which the existing requirements could be adapted to the changes in the monetary system. It therefore based its

examination on the assumption that, within the framework of Article II:6(a), the link between depreciations and specific duty adjustments should be maintained. Recognizing however that this link may not yield satisfactory results in all circumstances the Working Party concluded that the CONTRACTING PARTIES should respond flexibly to requests for specific duty adjustments submitted in accordance with Article II:6(a). They should adopt guidelines for their consideration of such requests so as to ensure reasonably uniform and predictable decision-making but at the same time stand ready to examine any request in detail if they consider, or an individual contracting party considers, that an adjustment of specific duties in accordance with the guidelines would impair the value of concessions.

8. The Working Party then turned to the question of how the depreciation of a currency should be measured in the present monetary situation. It based its analysis of this question on two reports prepared by the Fund at its request (cf. above paragraph 4). The Working Party noted from these reports that there were essentially three ways in which the depreciation could be measured for the purposes of Article II:6(a). First, the depreciation could be measured in terms of a common numeraire consisting either of one major currency, such as the United States dollar, or a basket of currencies, or an international unit of account, such as the Special Drawing Right (SDR). Second, the measurement of the depreciation could be tailored to the exchange arrangement chosen by the contracting party wishing to adjust its specific duties. If the contracting party maintained a value for its currency in terms of the SDR, the depreciation would be measured in terms of the SDR; if the contracting party maintained a value for its currency

in relation to the United States dollar, the depreciation in terms of the dollar would be decisive; and so forth. Third, the depreciation could be measured in terms of the currencies of the trading partners of the contracting party wishing to adjust its specific duties, in other words, the average effective depreciation of the currency would be taken as a yardstick.

9. The Working Party recognized that the use of a common numeraire for measuring the depreciation had the advantage that the change in the currency value was easy to compute and that there existed units of account, such as the SDR, that were internationally agreed and that provided a relatively stable standard for measuring currency movements. It noted however two major shortcomings of this approach. First, the size of an exchange rate change measured in terms of a common numeraire does not necessarily correspond to its impact on trade. For instance, the size of the depreciation of a currency measured in terms of United States dollars would normally not reflect the trade impact of that depreciation if the country concerned trades not only with the United States or countries whose currency is pegged to the dollar but also with other countries. Second, with a common numeraire, the possibilities of the contracting parties to avail themselves of Article II:6(a) would depend on whether their currency was, or formed part of, the chosen standard. For instance, if the United States dollar were selected as the common standard, the United States could never avail itself of Article II:6(a). Similarly, if the SDR were selected, the contracting parties' possibilities under Article II:6(a) would vary

depending on whether, or to what extent, their currency formed part of the SDR basket of currencies. The Working Party noted that similar problems would arise if the method for measuring the depreciation would be tailored to the exchange arrangement chosen by the contracting party wishing to adjust its specific duties. The possibilities under Article II:6(a) would then differ from one contracting party to the other according to their exchange rate system. This approach would moreover give rise to significant practical problems if the contracting party switched from one exchange arrangement to another during the course of the depreciation or if its exchange policies were not clearly determined. The Working Party reached for these reasons the conclusion that it would be preferable to take the average effective depreciation of the currency as a basis for specific duty adjustments under Article II:6(a).

10. The Working Party then discussed the question of what weight should be assigned to the various currencies of the trading partners in calculating the average effective depreciation. It noted from the Fund reports that the weights to be assigned to each currency should correspond to the purpose for which the average effective depreciation was calculated. The Working Party agreed that, for the purposes of Article II:6(a), the weighting should capture the impact of the currency movements on import prices and that the currencies should therefore be weighted by their shares in imports. The representative of the Fund advised the Working Party that an index of

import-weighted exchange rates was not difficult to construct and could in general be based on data contained in "Direction of Trade" published monthly by the Fund.

11. After having established how depreciations should be measured the Working Party examined which period of exchange rate movement should be taken into account for the purpose of measurement. The Working Party noted that in the past practice of the GATT the relevant period was the period that had elapsed since the specific duties were formally bound in a GATT schedule or had been adjusted in accordance with Article II:6(a). The Article itself refers to the period since the date of the General Agreement, that is 30 October 1947. If it 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 contain 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). The Working Party agreed that the past practice should be continued and that the relevant period of exchange rate movement should be the period following the date of the legal instrument through which the specific duties were formally bound or the date of the last adjustment in accordance with Article II:6(a), whichever date was later.

12. The view was expressed within the Working Party that there should be a limit on the interval which may elapse between the depreciation and the duty adjustment. It could be assumed that the economy had adapted to the erosion of specific duties if these had not been increased promptly after the depreciation, and recourse to Article II:6(a) then seemed inappropriate. Another view was that the effect of the erosion could sometimes only be detected after many years and governments therefore needed to retain their rights under Article II:6(a); moreover, periodic reductions of specific duties in tariff negotiations would largely eliminate the problem since only depreciations following the date of the last binding of the duties would be taken into account. The Working Party, noting that Article II:6(a) imposed no time-limit and that it was not its mandate to propose changes in the application of this provision that were not warranted by the changes in the monetary situation, agreed that contracting parties should retain their rights under Article II:6(a) even if they had not made use of them promptly after the depreciation. However, the Working Party considered that it could reasonably be assumed that the contracting parties had examined the protective incidence of their specific duties during the course of the Multilateral Trade Negotiations and were not presently planning to raise them to take into account past depreciations. It therefore recommends that

the guidelines it proposes for decisions under Article II:6(a) be applied only to depreciations after the adoption of the guidelines by the CONTRACTING PARTIES.¹

13. The Working Party agreed 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 and non-reversible exchange rates were compared for the purpose of determining the size of the depreciation. The Working Party, after having examined the results of a statistical exercise by the Fund staff showing the implications of alternative methods of measuring recent exchange rate movements, agreed that this aim could generally be achieved if the average exchange rates over two three-month periods that were at least one year apart were taken as a basis. The requirement of a depreciation of more than twenty per cent contained in Article II:6(a) would serve as a further safeguard against specific duty adjustments based on temporary or reversible depreciations. Even with these safeguards it could however not be excluded that the depreciation was followed by a sharp appreciation. The Working Party therefore recommends that the CONTRACTING PARTIES, when granting their concurrence under Article II:6(a), retain, for a period of one year, the right to withdraw or modify their authorization if the depreciation on which they based their concurrence is subsequently reversed.

¹It was understood in the Working Party that this should not apply to the pending request for the approval of specific duty adjustments submitted by Israel to the Council in March 1978 (C/M/124).

14. The Working Party examined the question of whether the application of Article II:6(a) should in the present monetary situation be symmetrical, that is whether contracting parties whose currency appreciated should be required to reduce their specific duties. One member of the Working Party pointed out that an appreciation designed to offset inflation abroad tended to stabilize import prices and hence also the ad valorem incidence of specific duties. If import prices declined as a result of an appreciation, the ad valorem incidence of specific duties would tend to increase; at the same time however the lower import prices would normally lead to a decline in the competitiveness of the domestic industry and to greater import penetration. In neither case would the competitive opportunities resulting from specific duty concessions be impaired. The Working Party agreed not to pursue this matter noting that Article II:6(a) did not deal with appreciations and that contracting parties could resort to Articles XXII and XXIII of the General Agreement if they considered that an appreciation impaired in a particular case the value of specific duty concessions.

15. The Working Party studied the question of how specific duties defined not in the domestic currency but in a foreign currency, a basket of currencies or an international unit of account should be dealt with. The Working Party agreed that, if this case were to arise in practice, the depreciation to be taken into account should normally be the depreciation of the domestic currency equivalent of the chosen unit so as to achieve equality of treatment with contracting parties defining their specific duties in their domestic currency. The Working Party further analyzed the

case of contracting parties members of a customs union with common specific duties but no common currency that define their specific duties in terms of a unit of account composed of the currencies of the member States. It noted that the European Community defines the specific elements in its common customs tariff in terms of the European Unit of Account. The Working Party recognized that the common unit of account served in such cases as a substitute for a common currency and it therefore concluded that the depreciation to be taken into account should in these cases normally be the depreciation of the value of the unit of account in terms of third currencies each weighted by its share in the total imports of the common market.

16. The Working Party debated whether individual examinations of specific duty adjustments under Article II:6(a) should be conducted in working parties, panels or in the Balance-of-Payments Committee. One view was that an examination in the Committee would be administratively convenient, ensure uniform decisions and facilitate consultations with the IMF. Another view was that an examination in ad hoc bodies would be preferable since their composition could be adapted more easily to the trade interests involved.

The Working Party reached the conclusion that this point should be decided by the CONTRACTING PARTIES as practical cases arose.

17. According to Article II:6(a) only exchange rate changes consistent with the Articles of Agreement of the International Monetary Fund are to be taken into account. The Working Party agreed that this requirement

should be retained and that the CONTRACTING PARTIES should therefore ask the Fund to give its views regarding the consistency of the change in the exchange rate of a contracting party with Article IV of the Articles of Agreement of the Fund, in particular the part that provides that Fund members shall "avoid manipulating exchange rates ... to gain an unfair competitive advantage over other members." The Working Party further agreed that the CONTRACTING PARTIES should, in accordance with the provisions of Article XV:2 of the General Agreement, ask the International Monetary Fund to provide factual information regarding changes in the exchange rate of its members and to calculate the extent of the depreciation in accordance with the method for the calculation established by the CONTRACTING PARTIES for the purposes of Article II:6(a), and on the basis of available data. The representative of the Fund informed the Working Party that the Fund would be ready to give assistance to the CONTRACTING PARTIES in these matters.

18. The Working Party discussed which procedures should apply to requests submitted under Article II:6(a) by contracting parties that are not members of the Fund. It noted that this matter was dealt with in Article II:6(b) of the General Agreement and in the accession protocols of the contracting parties that were not members of the Fund. The Working Party did not consider it necessary to propose any changes in the existing arrangements for non-members of the Fund.

19. In the light of the above considerations the Working Party recommends that the CONTRACTING PARTIES adopt the guidelines for decisions under Article II:6(a) set out in the Annex.

ANNEX

Guidelines for decisions under Article II:6(a) of the General Agreement

In the present monetary situation the CONTRACTING PARTIES shall apply the provisions of Article II:6(a) as set out below unless they consider that this would lead in the circumstances of the particular case to an impairment of the value of a concession:

- (a) If a contracting party, in accordance with Article II:6(a) of the General Agreement, requests the CONTRACTING PARTIES to concur with the adjustment of bound specific duties to take into account the depreciation of its currency, the CONTRACTING PARTIES shall consult with the International Monetary Fund to determine the size of the depreciation of the currency and the consistency of the depreciation with the Fund's Articles of Agreement.
- (b) The size of the depreciation shall be determined by comparing the import-weighted average exchange rate during the three months preceding the date of the adoption of the present guidelines or the date of the legal instrument through which the specific duties to be adjusted were last bound or the date of the last adjustment of the specific duties in accordance with Article II:6(a), whichever date is later, with the import-weighted average exchange rate during the three months preceding the contracting party's request. At least one year shall have elapsed between the relevant base date and the contracting party's request. If a contracting party does not define its specific duties in terms of its domestic currency but in terms of another unit

(e.g. one or several other currencies or an international unit of account) the depreciation to be taken into account shall be the depreciation of the domestic currency equivalent of the unit chosen. If contracting parties members of a customs union define their common specific duties in terms of a unit of account composed of the currencies of the members, the depreciation to be taken into account shall be the average depreciation of the unit of account in terms of the currencies of third countries each weighted by its share in the total imports of the customs union.

- (c) The CONTRACTING PARTIES shall be deemed to have authorized the contracting party to adjust its specific duties to take into account the depreciation if the International Monetary Fund advises the CONTRACTING PARTIES that the depreciation calculated as set out in paragraph (b) above is in excess of twenty per cent and consistent with the Fund's Articles of Agreement and if, during the thirty days following the notification of the Fund's advice to the contracting parties, no contracting party claims that a specific duty adjustment to take into account the depreciation would impair the value of a concession. If such a claim is made the adjustment shall be deferred pending consultations between the contracting parties concerned. If, after such consultations, the claim is maintained the question shall be decided by the CONTRACTING PARTIES.

- (d) If, during the year following the contracting party's request, a contracting party claims that the value of a specific duty concession adjusted in accordance with the above procedures is impaired because the depreciation is partly or fully reversed, the CONTRACTING PARTIES shall examine the matter and, if appropriate, modify or withdraw their authorization.