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Committee on Balance-of-Payments Restrictions

REPORT ON THE 1995 CONSULTATION WITH BRAZIL

1. The WTO and the GATT 1947 Committees on Balance-of-Payments Restrictions consulted jointly with Brazil on 5 and 9 October 1995. The consultation was held under the Chairmanship of Mr. P. Witt (Germany), in accordance with the Committees' terms of reference, pursuant to Article XVIII:B, paragraph 12 (a) of GATT 1994 and the Understanding on the Balance-of-Payments Provisions of GATT 1994. The International Monetary Fund was invited to participate in the consultation in accordance with Article XV:2 of GATT 1994.

2. The Committee had the following documents before it:

Basic document supplied by Brazil	WT/BOP/5
Background paper by the Secretariat	WT/BOP/W/7
Notification by Brazil under Paragraph 9 of the Understanding on the Balance-of-Payments Provisions of GATT 1994	WT/BOP/N/4
Notification by Brazil in Pursuance of Paragraph 3 of the Understanding and the Decision on Notification Procedures	WT/L/73

International Monetary Fund

Brazil, Supplementary Background Material for the
WTO, dated 18 September 1995.

Opening Statement by the Representative of Brazil

3. The opening statement of the representative of Brazil is attached as Annex I.

Statement by the Representative of the International Monetary Fund

4. The statement made by the representative of the International Monetary Fund is attached as Annex II.

Discussion in the Committees

1. Balance-of-Payments Position and Prospects

5. Members commended the Brazilian Government for the successful implementation of the Real Plan introduced in 1994. They expressed their full support for the economic stabilization package that had achieved the creation of macroeconomic conditions for sound and sustainable economic development, the major liberalization of the trade régime and the harnessing of inflation.

6. Members, however, expressed serious concern regarding the frequent adjustments in tariff rates and recourse to import restrictions introduced in the first half of 1995 which indicated a reversal of the positive steps taken in trade liberalization and risked undermining the international confidence in the success of the Real Plan.

7. With regard to Brazil's invocation of Article XVIII:B of GATT 1994 for Provisional Measure 1024 of 13 June (WT/BOP/N/4), Members observed that the root causes of the deterioration in Brazil's balance-of-payments position in early 1995 were the rapid adjustments in macroeconomic variables brought about by the introduction of the Real Plan. In their view, the trade deficit reflected a surge in imports since the end of 1994 generated by rising domestic demand, in large part fuelled by strong economic growth, increasing real wages and credit expansion. The trade liberalization measures introduced in the Fall of 1994 had also contributed to the increase in imports. The sharp drop of the monthly rate of inflation following the introduction of the Real Plan and the appreciation of the nominal exchange rate as well as the significant trade liberalization steps taken in the Fall of 1994 had further stimulated this growth. Steps taken by the authorities to tighten monetary conditions in the first months of 1995 had not been sufficient to curb the rapid expansion of overall demand. The widening of the trade deficit had translated relatively quickly into a shift in the current account from the surpluses posted in the past several years to a deficit of around US\$4.2 billion at the end of 1994. This development, coupled with an increasing deficit in the services account, had led to the widening of the current account gap in the first half of 1995. However, the trade account had returned to balance in July 1995, and had registered a surplus of US\$328 million in August 1995. Members did not share the Brazilian view that the relatively more rapid growth of motor vehicle imports had been largely responsible for the deterioration in the current account in the first months of 1995, thereby justifying the introduction of the Provisional Measure relating specifically to that sector.

8. Most members also considered that the evolution of Brazil's international reserve position did not indicate a threat of "a serious decline" in Brazil's monetary reserves. Brazil had been able to maintain a substantial level of reserves throughout the Real Plan period. At the time when the Provisional Measure was issued in June 1995, reserves stood at the equivalent of 8.8 months' of imports - some four times the level at the time Brazil disinvoked Article XVIII:B in 1991 and more than twice the minimum required level established by the Brazilian Senate. The reserve position had, moreover, strengthened steadily since May 1995 to reach US\$47.6 billion in August 1995, representing nearly 12 months' imports. The fall in Brazil's debt-service ratio, at the same time, also alleviated balance-of-payments pressures. In their view, the level of reserves appeared adequate to deal with temporary adjustment difficulties associated with the implementation of the Real Plan and the turmoil in capital markets seen in early 1995.

9. Members also gave their view regarding the systemic implications of the present consultations, Brazil being the first Member seeking Article XVIII:B justification for a new measure under the balance-of-payments provisions of the WTO. It was remarked that concerns regarding a short-term balance-of-payments situation should not affect a Member's compliance with contractual disciplines and commitments under the WTO Agreements and, in this particular case, compliance with Article XVIII:B. Should certain other developing Members facing similar balance-of-payments situations follow Brazil's example, the global trading system itself could be in jeopardy. It was important to preserve the spirit and the letter of Article XVIII:B.

10. Given the above considerations, Members maintained that the import restrictions contained in the Provisional Measure could not be justified under Article XVIII, paragraph 9 and requested the early removal of quantitative limitations.

11. One Member noted that Brazil's balance-of-payments situation could not be considered critical compared to those of many other developing countries. Another Member recalled that, despite a serious balance-of-payments crisis experienced in late 1994, his authorities had not considered any action under Article XVIII:B. The volatility of capital flows in early 1995 had proved temporary and Brazil's reserves had not reached a level that constituted a critical balance-of-payments situation. For another Member, equilibrium in the multilateral trading system would not allow each and every country to compensate for capital account losses with a trade surplus. The balance-of-payments provisions were not designed to address a crisis situation associated with a potentially volatile capital account.

12. Some Members stated that the Brazilian authorities' assessment of the balance-of-payments situation deserved sympathetic consideration. They stated that it may not always be opportune to take into account only the number of months' of imports covered by total reserves; the structure of the reserves and the likely movement of its various components was also important. While it might be argued that Brazil's balance-of-payments had not reached a critical situation in terms of the Understanding, no members' interests would be served if a critical situation was allowed to develop to unmanageable levels before any remedy was sought. For a country that reached a critical situation, it was difficult to plan in advance the appropriate reaction and the options available to it were limited. These Members therefore considered that the "critical situation" in the Understanding should be read in conjunction with Article XVIII, paragraph 9(a) which allowed import measures "to forestall the threat of a serious decline" in monetary reserves. One Member stated that the measure had economic legitimacy since, under the financial circumstances of early 1995, it would have been difficult to support a trade deficit of US\$5 billion. In the concluding session (9 October) a further Member associated itself with this view.

13. The representative of Brazil stated that the stabilization of inflation was a precondition for sustainable economic growth, in particular for his country where the annual rate of inflation had reached three-digit levels in the past ten years. His authorities had made all feasible efforts to take appropriate monetary and exchange rate policies to curb excess demand, which had been fuelled by the effect of the drop in the inflation tax on consumers. However, any changes in macroeconomic variables were complex and took time.

14. The assessment of the balance-of-payments situation based on ratios of months' of imports to total reserves, was static and ex-post and did not take into account the impact of the globalization of international financial markets on short-term capital movements. A sound assessment of the balance-of-payments situation should take into account the composition of reserves, in addition to the amount of reserves. He recalled that in a currency attached reserves could fall very rapidly; for example, in March and April 1995, US\$500 million of reserves had been lost on two occasions in a single day by Brazil. Operators in financial markets based their expectations on the ability of developing countries to fund annual current account deficits of over 2.5 per cent of their GDP and on the exposure of their portfolio positions. Based on those considerations, the amount of finance allocated to Brazil, like other emerging markets, had shrunk in February and March 1995. His authorities had reacted to the unpredictability created by the fast erosion of the reserves early in the year by effective fiscal and monetary policies, adjustment in the exchange rate, tariff increases and finally the introduction of the Provisional Measure 1024. The quantitative limitations, introduced as part of a comprehensive approach for the second half of 1995, should be seen as a cautionary measure in response to the adverse developments early this year.

15. The representative of Brazil continued that while ensuring the effective implementation of the stabilization programme through appropriate macroeconomic and structural policies, the Brazilian authorities also had to find a compromise solution to the short-run problem of surge in demand and

rapid movements in reserves. Brazil remained on the main track of stabilization and structural reforms that were essential to sustainable development in an open economy. The authorities were committed to continued reductions in tariffs and further trade liberalization; they had a long-term interest in the sustainability of the process and the successful conclusion of the stabilization plan, after many years of high inflation.

II. Alternative Measures

16. Members gave their comments on alternative measures without prejudice to their views regarding the overall balance-of-payments situation of Brazil. They supported the IMF assessment that a substantial strengthening of public finances was fundamental if the worsening of the trade deficit were to be reversed in an efficient and sustainable way. Members recognized that the Brazilian authorities were committed to the Real Plan which provided a basis for the necessary measures. The trade measures taken in early 1995, combined with further tightening of monetary policy, had substantially restored the trade balance and increased the reserves. Brazil's trade account had been in balance in July and August, thus proving the adoption of Provisional Measure 1024 in June 1995 unnecessary.

17. One Member pointed out that import restrictions were disproportionate to the problem of capital volatility faced by the Brazilian authorities. Given the long-standing nature of this problem faced by many Members, this would imply the ability to have permanent recourse to Article XVIII, which would then cease to be an exception. The solutions should be sought in the financial realm. Some other Members suggested that other policies such as acceleration of structural reform or greater flexibility in the determination of the exchange rate could help to improve the productivity and competitiveness of the Brazilian economy. Some Members, however, emphasized that developing countries required time for any positive results in structural reforms to be achieved. For one Member, the fact that trade measures had improved Brazil's balance-of-payments situation demonstrated that the measures should be taken before the crisis was fully developed.

18. In response to a question on the effectiveness of the policy mix, the representative of the IMF expressed the IMF staff's view that a tighter fiscal stance would help to reduce interest rates and thus help to ease pressure on monetary policy. This change would enhance the credibility of the authorities' inflation-reduction policy and thus further strengthen the Real Plan. The Brazilian tax system had become very complex over the years as a result of adjustments made to revenue collection in a high inflationary environment and numerous incentives, exemptions and deductions had eroded the tax base substantially. While recognizing substantial progress in the past year and the practical difficulties associated with fiscal tightening in a federal system of government, there was still large scope for improvement in the revenue structure.

19. The representative of Brazil stated that the Government had submitted to the Congress a series of tax reform bills. He acknowledged that the fiscal situation in Brazil had worsened because of problems of controlling fiscal administration at the level of twenty-seven states and municipalities. After complex and delicate negotiations with local governments, bills covering a broad reform of corporate income tax legislation and social security tax had been presented to the Congress in the first half of this year. Furthermore, the process of tax collection had been streamlined through the issue of a provisional measure. Tax reform required constitutional amendments, a legally complex and time-consuming process.

20. In addition to trade measures, Brazil had recently taken a whole series of financial measures in order to remedy the inconveniences caused by the short-term component of its reserves and the effects of volatile capital flows. These measures included an increase in the tax on foreign investments in

fixed-interest securities; certain restrictions on foreign investments in local derivatives; introduction of differentiated tax rates on investments in debt instruments to favour longer-term investment; introduction of a tax on financial flows in the floating exchange-rate market, through which a large proportion of short-term capital flows took place without the prior control of the Central Bank; and introduction of differentiated corporate tax rates favouring longer-term portfolio and equity investment. In early 1995, Brazil had undertaken a process of reforms for the removal of constitutional constraints to direct foreign investment in relevant sectors of the Brazilian economy. The privatization programme also encouraged the use of foreign debt instruments.

III. System and Method of Restriction

21. Members considered that the import quota established by Provisional Measure 1024 of 13 June 1995 did not meet the criteria set out in the balance-of-payments provisions of GATT 1994 and the related Understanding. They emphasized that their observations in this area were made without prejudice to the earlier remarks relating to the justification of these measures on balance-of-payments grounds.

22. Members noted that, notwithstanding the provisions in Article XVIII:B, paragraph 9, as reaffirmed in the Preamble to the 1979 Declaration and further confirmed in the Understanding, allowing a Member to apply across-the-board measures to alleviate balance-of-payments problems under certain circumstances, Brazil's measures were not imposed to "control the general level of its imports" but to limit selectively the imports in the motor vehicle sector, which accounted for some 9 per cent of total imports. Even though imports of automobiles had increased rapidly during the period, this by itself was not a sufficient reason for targeting this sector.

23. The terms of Article XVIII:B, paragraph 10, permitted limited exceptions from the restrictions on the general level of imports, as necessary, for imports of products essential to economic development. Rather than excluding a list of "essential imports", the Provisional Measure excluded 92 per cent of total imports.

24. Notwithstanding the obligation to give "preference to those measures which have the least disruptive effect on trade", Brazil had not used "price-based measures" as prescribed in paragraph 2 of the Understanding; had not complied with the requirement in paragraph 3 to "seek to avoid the imposition of new quantitative restrictions for balance-of-payments purposes unless, because of a critical balance-of-payments situation, price-based measures cannot arrest a sharp deterioration in the external payments position"; and had not provided "justification as to the reasons why price-based measures are not an adequate instrument to deal with the balance-of-payments situation" in terms of paragraph 3 of the Understanding. It was also remarked that the Brazilian introductory statement incorrectly argued that the autonomous increase in tariffs introduced earlier were to be considered price-based measures in terms of paragraph 2 of the Understanding. The tariff increases had not breached Brazil's bound duty rates and therefore could not be considered as measures taken for balance-of-payments purposes.

25. Members also questioned the simultaneous application of tariff increases and import quotas. Brazil had resorted to quantitative limitations prematurely on 13 June 1995 - with only two and a half months of interval - before the authorities could have had time to assess the impact on the demand for imports of the rise in import duties from 32 to 70 per cent on 29 March 1995.

26. Concerning the cumulation of measures it was also noted that additional charges over and above the applied tariff rates, collected through the public bidding process as set out in the Sole Paragraph of Article 9 of the Provisional Measure, could amount to yet another "price-based measure". Some Members also noted that Provisional Measure imposed both quota limitations on import of automobiles and TRIMS to encourage domestic production and exports in the same sector.

27. It was also noted that Brazil had not publicly announced a time-schedule for the removal of the measures nor a justification for not submitting such schedules as required in Article XVIII:B, paragraph 11(b) and in paragraph 1 of the Understanding, and that information on imports of motor vehicles during the months following the introduction of the quota had not been provided to satisfy the transparency requirement in paragraph 4 of the Understanding.

28. A number of Members, while noting the Chairman's comment that the incentives to production, investment and exports provided for in the Provisional Measure fell outside the scope of the present consultation, expressed concern regarding the compatibility of the envisaged measure with the various provisions of the Agreement on Trade-Related Investment Measures (TRIMs Agreement). The combination of import restrictions with TRIMs suggested that the Provisional Measure was aimed at developing industrial policies that would put Brazil on a par with its MERCOSUR partners in this sector.

29. The representative of Brazil stated that in addition to the adoption of all fiscal and monetary measures that could contribute to the correction of the balance-of-payments disequilibrium, his authorities had resorted to tariff increases on 109 products, including motor vehicles. These increases were made within the limits of its commitments under the schedules attached to the Marrakesh Protocol. Tariff increases on motor vehicles had not been effective in countering the balance-of-payments difficulties. Had the import restrictions be extended across-the-board, Brazil's trading partners would have been worse off.

30. He also stated that the quantitative limitations on motor vehicles in Provisional Measure 1024 were a framework measure which, nonetheless, were justified under the balance-of-payments provisions. The quantitative limitations in the Provisional Measures might, or might not, come into effect; Brazil could not withdraw a restriction that was not presently being applied. In order to comply with the transparency requirements under Article XVII, Brazil had notified the measure that was in place for balance-of-payment purposes. The present consultations with the Committee were held to provide maximum clarification on a measure that had a clear bearing on Brazil's obligations and should not be taken to signify that Brazil had breached any of its obligations under the relevant provisions.

31. The representative of Brazil said that tariffs had been increased on a number of other products. Brazil had to envisage quantitative limitations for the motor vehicles sector as a result of a number of circumstances, including the pivotal rôle that this sector played in the economy. The measure could not be considered as part of a policy to protect the motor vehicles sector. Tariff increases were measures that affected the price of imports even though they did not violate GATT obligations. Having raised tariffs within the bound rates, Brazil did not have to justify them under Article XVIII:B.

32. The reference to price-based measures in the balance-of-payments provisions did not preclude the use of other import restrictions. The need was seen to resort to quantitative limitations in the motor vehicles sector because, unlike other imports, tariff rate increases in this case had not been sufficient to stop the deterioration of the trade balance, *inter alia* because of favourable foreign financing conditions and reduction of profit margins by dealers. The quantitative limitations in place were pre-emptive measures to avoid balance-of-payments difficulties. Under the circumstances of 12 June 1995, the Brazilian Government had to assume the responsibility of taking such measures. Given the overall

balance-of-payments situation of the first quarter of 1995, Brazil had to resort to trade measures in this particular case since recourse to other available measures had been exhausted.

33. The representative of Brazil also stated that the Provisional Measure was introduced in June 1995 to address the immediate problem of a threat of deterioration in the balance-of-payments position through the imposition of quantitative limitations in the short term. In the Brazilian legal system, Provisional Measures were used to deal with urgent situations; the measures were subsequently sent for Congressional and Presidential approval.

34. In order to forestall the medium- and long-term balance-of-payments problems, the Provisional Measure also included certain longer-term measures related to investment incentives, production and trade in the motor vehicles sector. Those measures, which had the objective of attracting longer-term investment, were to be enforced as of 1 January 1996 under the provisions of Article 4 of the TRIMs Agreement. The Provisional Measure did not spell out the full details of the trade-related investment measures, since the relevant regulations had not yet been issued. Brazil would be prepared to consult with the Committee, should justification for those measures be sought under the balance-of-payments provisions. Both the quantitative limitations for 1995 and the investment régime that was proposed for 1996-1999 were presently framework measures that the Brazilian authorities had wished to bring to the attention of Members.

35. Several members noted that, whether the quantitative limitations might or might not come into effect, Brazil had already projected a programme of incentives for production, trade and investment, to come into effect from 1 January 1996, which was claimed as a potential remedy to a potential problem of balance-of-payments. Although many Members recognized the problem of volatility of the capital account, they stressed that on the basis of the current situation, Brazil had not encountered a serious balance-of-payments situation that could justify the Brazilian measures in terms of Article 4 of the TRIMs Agreement. In response, the representative of Brazil stated that the investment measures had been brought to the attention of the Committee for transparency. The justification for the measures could only be examined by the Committee once the relevant regulations were issued.

36. One delegation questioned the statement by Brazil that the quantitative limitations were not being applied at present, given that the specific level and duration of the import limitations had been established in the Provisional Measure. In response, the representative of Brazil stated that the quantitative limitations were notified because they were in force. However, they were not being applied at present because, imports of motor vehicles had not reached the quota ceilings as a result of the effect of the earlier tariff increases. No auctioning of quotas had taken place.

37. One Member asked whether an importer who had paid tariffs was also required to obtain an import licence; if any licences on motor vehicle imports were automatic or non-automatic; and whether all requests for licences had been granted. For another Member, even if the quota ceiling had not been reached, the quota was still in place because, should the ceiling be reached at any time before the end of the year, imports of vehicles would stop.

38. The representative of Brazil informed the Committee that 300,000 units of motor vehicles had been imported up to 13 June 1995, 50 per cent more than the amount compared to the same period in 1994. From 13 June to end-August a further 50,000 motor vehicles, that had been ordered or shipped prior to 13 June 1995 and exempt from the quota, had been cleared by customs in accordance with Article 10 of the Provisional Measure. An import quota of 150,000 units was set in addition to the amount of 350,000 units that had already been imported up to end-August. The quota could thus have a restrictive effect only when imports before end-1995 reached 500,000 units. One Member

remarked that there seemed to be a residual quota that had not been used up and asked, out of the 50,000 units imported after 13 June, how many were transactions that had been carried out prior to 13 June and how many were ordered after the issue of the Provisional Measure.

39. In response to questions by several Members concerning any specific treatment accorded to imports of motor vehicles from MERCOSUR partners, the representative of Brazil stated that, under Article 10 of the Provisional Measure and in accordance with its obligations under the MERCOSUR Agreement, Brazil would grant each partner treatment symmetrical to the one that Brazil would receive. The application of any quantitative limitation under the Provisional Measure would be non-discriminatory. Argentina was one of the countries that had a special sector-specific régime in the vehicle sector. Being a partner in the same initiative, Brazil sought to have a similar motor vehicles régime. One Member observed that, unlike Article XII, Article XVIII:B was not one of the GATT 1994 Articles, listed under paragraph 8 of Article XXIV, under which exemption from elimination of restrictions was allowed among members of a customs union.

IV. Effects of the Restriction

40. Members observed that quota limitations, whether "in place" or "not applied", had a distortive impact on trade. The combined effect of the rise in tariffs, the lack of transparency on the application of quantitative restrictions and the auctioning of licences was unnecessarily detrimental to the commercial and economic interests of countries exporting of motor vehicles to Brazil. One member note that the restrictions would inhibit adversely a third of its total exports to Brazil, while for some other Members, the exports of automobiles to Brazil had already been negatively affected by the announcement of tariff increases. Importers had cancelled previous orders and had not sought customs clearance for vehicles already on dockside.

41. Several members also considered that the Provisional Measure contradicted Brazil's overall trade liberalization programme, would adversely affect investors' confidence and would in the long run exacerbate the balance-of-payments problem. The proposed introduction of trade balancing and local content measures in the Provisional Measure would increase uncertainty and go against the declared objective of the Brazilian authorities to create greater stability in the capital account.

42. The representative of Brazil stated that the quantitative restrictions were in place as measures of a preemptive nature to avoid balance-of-payments difficulties. While the tariff increase to 70 per cent might have had an impact on the trade of motor vehicles, this measure was fully consistent with Brazil's obligations and commitment.

43. The representatives of Canada, Japan, Korea and the United States reserved the rights of their governments under other relevant WTO Agreements.

Conclusions

44. The consultations were based on the notification made by Brazil on 13 July 1995 (WT/BOP/N/4), invoking the provisions of Article XVIII, paragraph 9 of GATT 1994 and the Understanding on the Balance-of-Payments Provisions of GATT 1994, in respect of the import quota introduced under Provisional Measure 1024.

45. The Committees commended Brazil for the successful implementation of the Plano Real, launched in 1993, which included actions to strengthen fiscal and monetary policies and which had reduced inflation from approximately 50 per cent a month in June 1994 to under two per cent currently. They

observed that, under the programme, a sharp increase in domestic demand, together with liberalization measures and currency appreciation, had, *inter alia*, given rise to a surge in imports at the end of 1994 and in the first quarter of 1995. This trend led to a marked deterioration of the current account from November 1994. Rapid declines in reserves in December 1994 and March 1995 reflected both current account deficits and temporary outflows of short-term capital.

46. Given these circumstances, the Committees recognized the need seen by Brazil to maintain an adequate level and structure of reserves to preserve its credit-worthiness, to take steps in time to prevent a critical balance-of-payments situation from arising and, in particular, to avoid a "rush" to withdraw short-term capital. The Committees noted the IMF's statement that Brazil's international reserves stood currently at 12 months of imports and that potentially volatile short-term capital formed a high proportion of these reserves. Brazil maintained that its balance-of-payments position required the import quota in order to forestall the threat, as foreseen in Article XVIII:9(a), of a serious decline in its monetary reserves. Two delegations thought it advisable to take preventive action instead of letting a critical situation develop.¹ Some Members, however, found that there was no critical balance-of-payments situation; still others were of the view that there was no threat, as foreseen in Article XVIII:9(a), of a serious decline in Brazil's monetary reserves. The Committees were of the view that the circumstances did not justify the introduction of the import quota.

47. The Committees took note of Brazil's ongoing efforts in financial and tax reforms, recognising legal and technical complexities involved. The Committees shared the view of the IMF that further fiscal measures would increase the stability of Brazil's financial situation, enhance the credibility of macroeconomic policies and thus contribute to alleviating the potential volatility of Brazil's international reserves. While Brazil maintained that the import quota contained in Provisional Measure 1024 was also necessary, the Committees did not share this view.

48. The Committees, while noting the rationale given by Brazil for limiting the import quota to the automotive sector, recalled, *inter alia*, the provisions contained in the Preamble of the 1979 Declaration concerning the application of measures to specific sectors. Members expressed their views as to why the import quota was also inconsistent with a number of other criteria of balance-of-payments provisions. Details of these positions are reflected in the report.

49. The Committees noted the Brazilian statement that the import ceiling, established under Article 10 of the Provisional Measure and in force until the end of 1995, had not been reached. Members regretted the adverse effects of the existence of the measure on exports of automobiles to Brazil.

50. Brazil stated that the eventual introduction of investment measures would aim at responding to the problems caused by a large percentage of volatile capital in its reserves. Members, while recognizing that these measures were not the subject of this consultation, voiced concern over the conformity with WTO provisions of the incentives to investment, production and exports in Provisional Measure 1024.

51. Based on these considerations and to assure compliance with the balance-of-payments provisions, the Committees requested Brazil to withdraw the import quota.

52. A number of Members reserved their rights under the provisions of the WTO Agreements.

¹One Member associated itself with this view in the concluding session.

ANNEX 1

Opening Statement by the Representative of Brazil

In coming to this meeting, Brazil is driven by a concern regarding two fundamental aspects that guide our participation in the WTO: transparency and strict adherence to the multilateral trade rules.

The concern with transparency has been present since the publication of the Provisional Measure under review. Thus, on June 27, Brazil notified Provisional Measure 1024 based on the Uruguay Round *Understanding Regarding Notification Procedures*. On July 3rd, I informed the members of the Council for Trade in Goods about the Measure and stressed my willingness to provide delegations with any clarification deemed necessary.

Later, on July 13, the Measure was notified to WTO, as provided for in Article XVIII:B. Before the Summer break, we also held an informal meeting with a number of interested Members.

The document submitted by Brazil to these consultations contains an exhaustive and substantive explanation about the economic reasons that led Brazil to conceive of a set of measures to face the rapid deterioration of its balance-of-payments. In this context, I would like to share with the Members of the Committee some thoughts about the legal basis for invoking Article XVIII:B in this particular case.

Article XVIII:B is a provision of international economic law. It is part of a legal system the general scope of which has been to expand and liberalize trade and to ensure predictability by means of stable rules. That general scope has a *gauging* mechanism to regulate risks and absorb unpredictable circumstances, inherent to economic life. That is the reason the WTO system sets the conditions for exceptions to the application of its general rules.

In international economic law, the usual technique found in rules that contemplate exceptions is to set criteria that allow for the configuration of a legal *standard*. A case in point is GATT's Article XX that deals with General Exceptions. It allows for restrictions to international trade as a result of measures necessary, for example, *to protect public morals, to protect human, animal or plant life or health*, etc., as long as they pass the test of not being arbitrary or unjustifiably discriminatory between countries.

Article XVIII recognizes that it may be necessary for Members to take protective measures affecting imports. It admits a regime for a developing country *to deviate temporarily* from the provisions of the other articles of the General Agreement.

The *standard*, at the moment of its application, is a measure intended to assess whether in the variable specificity of circumstances, the behaviour of a member, when following the criteria, abides by principles such as *due diligence, reasonableness* and *fairness*.

In the assessment of *standards* in international economic law, it is important, when measuring the behaviour of a member State, to take into account not only the past but also the present and the future. That implies projections and scenarios, which are the modern methods to keep risks within the prudential limits given by *due diligence* and *reasonableness*.

Brazil is convinced that a strict *jurisprudence of concepts* is not adequate to the examination of a standard such as that of Article XVIII:B. An open "*jurisprudence of interests*" is adequate because

it is important to consider the medium and long term interests geared to the process of trade liberalization -- a process to which Brazil continues to be fully committed, as amply demonstrated in the Brazilian document.

I believe that as much as development must be sustainable—to refer to a concept acclaimed at the Rio Conference -- trade liberalization must also be sustainable. One of the main ingredients of sustainability of trade liberalization is the balance-of-payments situation, because of the links existing between monetary and trade affairs.

A country's reserves are a critical aspect of the balance-of-payments. According to paragraph 9 of Article XVIII, the *level of reserves* must be *adequate for the implementation of* the country's economic development program. Considering the risk of deterioration, *due regard* should be given to *special factors that may be affecting the reserves of the contracting party*.

The 1970 Declaration should be taken into account on this matter. It states that one of the objectives of the *consultations* on balance-of-payments is to *provide an opportunity for a free exchange of views contributing to a better understanding of the problems facing the consulting countries*. In the consultations *careful consideration* should be given to *special problems* and *account should be taken of all factors, both internal and external, which affect the balance-of-payments position of the consulting country*.

The examination of the *external factors* must be ample, as the then Chairman of the Committee on Balance-of-Payments noted in a statement made in 1984 concerning the general macro-economic environment and the heavy external debt that dramatically affected developing countries. It must be ample and can be ample because GATT's legal provisions suffice to provide legal coverage to a comprehensive assessment.

As a result of the volatility of capital flows exacerbated by the Mexican crisis, any analysis of the level of reserves must necessarily include the debate about the composition of such reserves.

One of the characteristics of the financial flows in the 1990s are financial savings channeled into highly volatile portfolio investments. As President Fernando Henrique Cardoso repeatedly affirmed, they constitute a problem of international governance. Any instability or threat of instability in the financial market has immediate repercussions on capital flows. That fact explains the risks -- for a country such as Brazil and those developing countries characterized as emerging markets -- of financing balance-of-payments deficits mainly through short term capital inflows. Those are precisely the Members for which the provisions of Article XVIII were envisaged.

In two critical months, December 1994 and March 1995, the Brazilian reserves declined by US\$ 7.3 billion. A sufficiently high level of reserves is required to preserve the country's credit worthiness and to avoid a "rush" to withdraw short term capitals. To restructure the reserves and to keep them at high levels, as Brazil has been doing, is therefore a macro-economic policy applied on the basis of the principles of *due diligence* and *reasonableness*. In June 1994, 66.4 % of the Brazilian reserves corresponded to short term capital, thus demonstrating the persistence of the balance-of-payments difficulties, in spite of the level of those reserves.

The reasons for the rigidity of the Brazilian current account are explained in our Basic document. While Brazil's commitments to the Paris Club and private banks were instrumental to the normalization of Brazil's relations with the international financial community, they introduced an element of rigidity in our current accounts. That explains the weight of interest payments that corresponded to 44 % of the US\$ 15 billion deficit in 1994. Other items causing the deficit are also related to the increasing Brazilian interaction with the world economy: profits and dividends (17%), transportation (15%), sundry services (12%) and international travel (8.4%).

How to finance that deficit? Until recently -- in part because of the external debt issue -- Brazil financed that deficit by reducing imports and expanding exports to generate significant trade surpluses. The trade liberalization policy adopted since the beginning of the 1990s and the subsequent implementation of the Plano Real shifted the emphasis away from the need to create trade surpluses

to a policy of price stabilization and inflation control. The positive trade performance in the first half of 1994 – responsible for 65 % of the US\$ 10.4 billion surplus of that year – was not repeated in the second semester, when, as a result of the Plano Real, imports increased significantly. That increase resulted from a demand surge caused by higher per capita income due to much lower inflation rates and from an increase in the purchase of capital goods and raw material designed to stimulate industry productivity. This was a domestic factor with unequivocal repercussion on the country's trade: during eight consecutive months (from November 1994 to June 1995), the trade deficit amounted to US\$ 5.5 billion. This situation resulting from the very success of the Plano Real is foreseen in Article XVIII:2: *high level of demands for imports likely to be generated by their programs of economic developments..*

The complete reversal of trade flows and their trends is clear: in the first half of 1995, imports increased by 93 % as compared to those of the first half of 1994 whereas exports increased by only 6.7 % as compared to the first half of 1994. A comparison of the items imported in the first halves of 1994 and 1995 indicates that the imports of consumer goods increased by 201 %, that is, by significantly more than raw materials and intermediate goods (82 %) and capital goods (79 %). That fact led to the increase of the minimum level of monetary reserves required by Brazilian Federal Senate Resolution at the time of the debt restructuring, that is, the equivalent to the value of imports for four months. That minimum was thus increased to US\$ 15.2 billion. Such requirement fully known by the international creditors and its purpose is to maintain the sustainability of the adequate capacity to pay the Brazilian debt.

In view of these circumstances, the Brazilian government adopted a series of measures that follow a responsible *due diligence* criterion. Such measures are not topical since they are part of an all-embracing and consistent economic development program. They encompass, *inter alia*, long and medium term policies, including exchange rate policies, measures to control aggregated demand, etc. Their purpose is to implement the stabilization process and simultaneously to modernize the economy of the country thereby promoting its harmonious insertion in the globalization process.

In fact, the continuing success of the stabilization process is an unfaltering priority of President Fernando Henrique Cardoso's government. This can be perfectly understood in a country that has had a two-digit inflation a month, has gone through the experience of various unsuccessful stabilization plans in the last years and which has finally reduced the inflation rate from approximately 50 % a month in June 1994 to a 2 % range a month since the Plano Real started. I do not think that it is necessary to elaborate on that point. I would nevertheless just like to recall, in that context, the widespread importance attached to what is considered a tolerable level of inflation for a sound economic policy.

Let me now turn to the consideration of the changes that have taken place in Brazil and their impact on the reordering of our trade agenda. The increase on imports, the rigidity of the current account deficit and the risks of financing those deficits with volatile short term capital, have compelled Brazil to curb the erosion of its reserves and to take steps to reduce trade deficit. Thus, during the first half of 1995 without departing from commitments undertaken in the Uruguay Round, my government raised import tariffs for 109 durable goods. That tariff increase, provided for in Decree 1457 of 29 March 1995, amended by Decree 1471 of 28 April 1995 was duly notified to the WTO.

Those *price-based measures* have had the desired results, except for the automotive sector. In fact, tariff rates for the automotive sector were raised from 32 % to 70 %. However, as a result of more favorable foreign financing conditions, foreign automobile dealerships were able to reduce their profit margins, keeping their prices only slightly higher than prior to the rate increase. That is the reason for the low impact of the tariff increase on imports of automobiles.

The Brazilian document contains specific data on the import surge of automobiles. In the first half of 1995, automobiles imports reached the level of US\$ 2.4 billion. In the first half of 1994 that same item represented 3.2 % of total imports. In the first half of 1995 it represented 9.2 % of the imports. Between January 1st and June 12, 1995 – the eve of the publication of the Provisional Measure – 299.700 units were imported—the equivalent to 31 % of the apparent consumption of automobiles. That represents an import increase of 447 % in relation to the first half of 1994, and contrasts with the 210 % import increase in the consumption of durable goods, in a total import growth of 93 %.

In view of that situation, as well as the projections and the implied risks to the balance-of-payments, the government of Brazil issued Provisional Measure 1024. It refers to the automotive sector alone, since it would not be *reasonable* to foresee import controls on a larger number of items traded. Actually, the tariff rate increase has had the desired result in relation to the remaining items covered by Decree 1471. The *due diligence* in the decision making process that led to the publication of Provisional Measure 1024 can be perceived in the four scenarios presented in the Brazilian document. The due diligence stems from the reality: in the first quarter of 1995 automobile imports increased by 566%, as compared to the first half of 1994. The scenarios projected by the Brazilian authorities indicated that, without trade measures, the deficits in the balance-of-payments could vary between US\$ 23.7 and US\$ 42.2 billion, that is, between 4.1% and 7.3% of the GDP.

Some data illustrate the argument. Importation of vehicles in February and March 1995 reached about US\$ 456 million. After the tariff rate increase, in April 1995, that value dropped to US\$ 267 million; it went up to US\$ 399 million in May and in June it reached US\$ 538 million - an amount higher than those reached in February and March, that had led to the adoption of the tariff rate increase.

The Brazilian government published Provisional Measure 1024 in order to counter the risks to (i) the continuity of the stabilization plan; (ii) to the Brazilian commitments that resulted from the restructuring of the debt; and (iii) to the sustainability of the trade liberalization. This results from an assessment that price-based measures - tariff rate increases for consumer goods, within binding limits for 1995 - did not have the necessary impact on the automotive sector. Having concluded that the tariff rate increase *per se* would not *arrest a sharp deterioration in the external payments position*, the Brazilian government, exceptionally and provisionally, adopted a framework for the introduction of *quantitative restrictions* on automobiles imports.

Provisional Measure 1024 provided for import limits in 1995 for vehicles with generous *reasonableness*, meaning that the exports to Brazil could grow as much as 132% when compared to the levels reached in 1994. If and when applied, such limits are to be administered in a non-discriminatory way.

The possibility of introducing restrictions for the year 1996 will be considered in the light of the evolution of the balance-of-payments performance. If they become necessary, Brazil will notify them to the WTO and will submit relevant data, and shall be prepared to discuss the matter multilaterally.

The Provisional Measure also contemplates the possibility ensuring the equilibrium in the balance-of-payments *on a sound and lasting basis*, by giving priority to the *desirability of assuring an economic employment of productive resources*, to use the language of Article XVIII:B.

On that matter, the first objective of Provisional Measure 1024 is to deal with the composition of the reserves, reducing their volatile short term components and increasing the medium and long term investments. That objective is of utmost importance in view of the risks involved in the financing of balance-of-payments deficits through short term portfolio investments. Hence the *incentives to investments, production and exports* to be granted to the automotive sector, as envisaged by Brazil. Such measures were conceived of in light of Article 4 of the *Agreement on trade-related investment measures*.

Why was the automotive sector chosen? This sector has a pivotal role in the Brazilian economy. It is responsible for 11% of the GDP; for 122.5 thousand direct jobs and for approximately 700 thousand indirect jobs; it is an integrated and diversified sector, encompassing all types of vehicles, tractors and equipment for agriculture, as well as parts and components. It represents an annual invoicing of US\$16 billion and generates government revenues the amount of US\$ 4 billion.

Brazil also considers that the investment decisions in the automotive sector in a globalized economy in the 1990s are conditioned by specific regimes, of a varied nature. Those regimes exist both in large markets of developed countries and in the markets of developing countries. Hence, for example, in the Agreement on Safeguards, the exception to Art. 2 provided for in the annex that

extends the validity period of the special agreement between the European Union and Japan regarding the automotive sector until 31 December 1999. This reality is also recognized in Article 5 of the Agreement on Trade-Related Investment Measures. It contemplates different terms for the phasing-out of TRIMs -- two years for their entry into force in developed countries; 5 years for developing countries; 7 years for least-developed members. Some of these regimes have been notified under Article 5 of the Agreement on TRIMs.

Among the Members that have notified TRIMs are Uruguay and Argentina which, together with Brazil and Paraguay are members of the MERCOSUL customs union. It is worth mentioning that each member State of MERCOSUL will maintain, for the moment, their regulations for the automotive sector. A harmonization of regulations through a common automotive regime is foreseen in one MERCOSUL's legal instruments.

This broader context which characterizes worldwide the specificity of the automotive sector, as a result of the principle *fairness*, is also invoked by Brazil so as to ensure an effective *economic employment of productive resources*, under the conditions prevailing in the international economic environment.

Those trade-related investment measures are not in force. Their implementation must be subject to regulation and shall not exceed December 31, 1999. In any case, the Provisional Measure only grants the Executive Branch the authority to implement those measures, which are not actually in force. When that occurs, the measures will be notified to the WTO.

The Brazilian delegation considers that the present consultation constitutes an excellent opportunity to build a foundation for legal assessments through *an intelligence gathering* in its double sense: the organization and selection of pertinent information and the possibility to apprehend what is relevant to understand the situation that led a State to invoke, in view of the circumstances, the exception to the general rule provided for in WTO's legal system.

I know that for an *intelligence gathering* process, details are important and as a newcomer not to the theory of GATT but to its practice, a maxim by La Rochefoucauld comes to my mind: *Pour bien savoir les choses, il faut en savoir le détail et comme il est presque infini, nos connaissances sont toujours superficielles et imparfaites.*

That is why - to well understand these things in their complexity -- my delegation, integrated by representatives of the Brazilian government with relevant responsibilities in the conduction of economic and trade policies are ready to provide further information, to clarify any details and to conduct with members of this Committee an open and constructive dialogue.

ANNEX 2

Statement by the IMF Representative

Over the past two years, there have been a number of major macroeconomic developments in Brazil, including the successful implementation of the *Real Plan*. In this statement, I will review briefly macroeconomic developments, focusing particularly on external developments, as background for assessing Brazil's recent resort to trade restrictions.

1. Economic background

In late 1993, the Brazilian authorities embarked on a well sequenced economic program, the *Real Plan*, to reduce inflation sharply and set the stage for sustained economic growth. Initially the program included measures to strengthen public finances, raise domestic interest rates in real terms, and synchronize price adjustments throughout the economy using a special unit of account. On July 1, 1994, the authorities introduced a new currency--the *real*--subject to a floor for the currency vis-a-vis the U.S. dollar, temporarily froze public enterprise prices, and limited price indexation. To help cope with upward pressures on the new currency and to improve the trade system, in September 1994 the authorities reduced import duties on approximately 5,500 items.

As a result of these policies and a strong nominal appreciation of the currency, inflation declined from an average of over 40 percent a month in the first half of 1994 to under 2 percent a month in the fourth quarter of 1994. Output growth accelerated from 4 percent in 1993 to almost 6 percent in 1994. The external current account was roughly in balance in 1994, and the overall balance of payments registered a surplus of close to US\$13 billion, reflecting in part large inflows of portfolio and other short-term capital from abroad.

In the first half of 1995, the authorities moved to contain domestic demand by tightening credit conditions. In this regard, the Central Bank relied mainly on increases in reserve requirements to keep lending interest rates high, and recently large open market sales have been conducted. Moreover, on June 30, 1995, new rules for wage contracts were introduced to eliminate backward-looking indexation of wages by mid-1996. Meanwhile, there was a considerable weakening in public finances in the first half of 1995 mainly because of higher expenditures. On the basis of current policies, the Fund staff projects that the primary surplus of the public sector will decline from 4 1/4 percent of GDP in 1994 to 2 percent of GDP in 1995.

Restrictions on credit and high real interest rates led to a drop in domestic demand starting in the second quarter of 1995. There was a pick up in inflation in June-July, owing in part to adjustments in some public prices and a depreciation of the currency. However, the monthly rate of inflation declined to 1 1/4 percent in August and, on the basis of preliminary information, is expected to decline further in September. In response to the slowdown in domestic demand, and in view of financial difficulties faced by some banks, reserve requirements were reduced gradually starting in May 1995.

On March 6, 1995 the authorities adopted an adjustable exchange rate band (initially set at R\$0.86-R\$0.90 per U.S. dollar and moved to R\$0.88-R\$0.93 per U.S. dollar on March 10) in response to downward pressures on the currency that originated in part from heavy capital outflows associated

with the Mexican crisis. After some initial instability resulting from uncertainty about how exchange rate policy would be managed, the new exchange system has functioned smoothly. The currency has been allowed to depreciate gradually since March, and the band has been adjusted twice, most recently in late June. Nevertheless, as of August 1995, Fund staff calculations show that the currency had appreciated by about 25 percent in real effective terms in relation to the level existing at the time the *real* was introduced when Brazil was considered to be quite competitive.

As has been documented more fully in our background paper to this committee, in response to the weakening trade balance, between February and August 1995 import duties on a wide range of goods were raised sharply for periods of up to one year. Over the same period, duties on other products were lowered to help reduce price pressures or facilitate investment. In June 1995 a Government decree introduced quotas on vehicle imports initially through end-1995, at which date the authorities indicated that they would reassess the situation, and reduced the import tariff on capital goods and raw materials for the automobile industry from 18 percent to 2 percent. The decree also authorized the imposition of trade balancing and local content requirements in the vehicle sector, but so far these provisions have not been implemented. In Brazil's notification to the WTO the measures pertaining to the vehicle sector were identified as being maintained for balance of payments purposes. The authorities have said that the trade regime for vehicles will be coordinated in the future with the regime for vehicles of its Mercosul trading partners.

The Brazilian authorities have made significant progress in their ambitious structural reform program in 1995. They have expanded the privatization program, and have obtained approval of constitutional amendments that should facilitate private participation in certain economic activities and ease restrictions on foreign investment in Brazil. They also recently sent to Congress proposals for constitutional amendments for the reform of the tax system and public administration. These proposals represent a framework for policy changes, that could play a key role in strengthening the public finances on a sustained basis. The quantification of their fiscal effects will be possible when implementing legislation is in place.

2. Balance of payments

Beginning in late 1994, there was a deterioration in the external trade accounts and the trade deficit totaled US\$4.3 billion in the first half of 1995 compared with a surplus of US\$6.8 billion in the corresponding period in 1994. The deterioration reflected the expansion of domestic demand, the effect of the liberalization measures introduced in September 1994, and the real appreciation of the currency. This turnaround was the main factor in the external current account shifting from a surplus of about US\$2 billion in the first half of 1994 to a deficit of US\$11 1/2 billion (or about 3.2 percent of GDP on an annual basis) in the first half of 1995. The surplus in the capital account declined sharply in the first half of 1995 mainly because of capital outflows—particularly in the first quarter—associated with the Mexican crisis. Reflecting the above developments, the overall balance of payments recorded a deficit of about US\$5 billion in the first half of 1995 compared with a surplus of about US\$16 1/2 billion in the first half of 1994.

The trade account registered small surpluses in July and August 1995, reflecting the downturn in economic activity and the trade restrictions that were introduced earlier in the year. On the basis of current policies, the external current account is projected to register a deficit of US\$17 1/2 billion (2.4 percent of GDP) in 1995, compared with a deficit of US\$1 1/2 billion (0.3 percent of GDP) in 1994. Despite the projected worsening in the external current account, the overall balance of payments is expected to register a surplus of US\$6 1/2 billion (about one half the level recorded in 1994) on

account of renewed inflows of capital. It should be noted, however, that the implied buildup in international reserves is dependent on the behavior of portfolio flows, which have shown sizable swings during 1995.

Gross international reserves declined from US\$38.5 billion at end-1994 to US\$33.4 billion at end-March 1995, as a result of the deteriorating trade balance and large capital outflows in the wake of the Mexican crisis. However, the decline stopped in the second quarter as capital inflows resumed, and reserves increased to US\$47.6 billion at end-August (equivalent to 12 months of projected 1995 merchandise imports) owing to a sharp increase in capital inflows in July and August. High nominal interest rate differentials, and possibly a reduction in perceived exchange rate risk following the exchange rate band adjustment in late-June, prompted large foreign portfolio investment and foreign borrowing by Brazilian residents.

In response to the strong capital inflows, on August 11, 1995, the authorities raised the taxes on investment by foreigners in fixed-income instruments and on bond placements abroad, and they prohibited new investment by foreigners in stock options and future markets. Notwithstanding these restrictions, Brazil's gross international reserves should remain close to 12 months of imports at end-1995.

3. Assessment

In many respects, the *Real Plan* has achieved impressive results. There has been a remarkable reduction in inflation, and there was an initial surge in economic activity. The authorities' approach has relied to a great extent on credit restraint and deindexation efforts. However, the authorities also have counted on a real appreciation of the currency and the freezing of public prices during the first year of the Plan. At the same time, after an initial fiscal tightening, the public finances have been allowed to weaken significantly and resort has been made to trade restrictions.

In the presence of an initial strong pickup in domestic demand, the policy mix has led to high real interest rates and a marked deterioration of the external trade balance. While international reserves have risen to high levels, this reflects large inflows of potentially volatile capital.

During 1995 the Brazilian authorities have resorted to trade restrictions, which are not appropriate to address Brazil's macroeconomic problems. Rather than resort to such restrictions, a substantial strengthening of the public finances is fundamental if inflation is to be lowered further and a worsening of the trade deficit is to be reversed in an efficient and sustainable way. Moreover, a tighter fiscal stance would help reduce interest rates by enhancing the credibility of the authorities' inflation-reduction policy and would take some of the burden of stabilization from monetary policy. The way of strengthening the fiscal stance was a key topic during the recent Article IV consultation mission to Brazil. In addition, the Fund has continued to provide technical assistance on improving tax administration.

Brazil's recent resort to trade restrictions, including quantitative restrictions on vehicle imports, is of particularly serious concern because of the distortionary nature of the restrictions. For these reasons, the trade restrictions should be removed at the earliest feasible date.