

WORLD TRADE ORGANIZATION

WT/BOP/W/21
12 September 2002

(02-4830)

Committee on Balance-of-Payments Restrictions

RESERVE ADEQUACY

Note by the Secretariat

This document has been prepared under the Secretariat's own responsibility and without prejudice to the positions of Members and to their rights and obligations under the WTO

I. INTRODUCTION

1. This Note has been prepared in response to a request by the Committee on Balance-of-Payments Restrictions at its meeting on 10 June 2002, in the context of the Committee's work on outstanding implementation issues under paragraph 12(b) of the Doha Ministerial Declaration.¹

2. To facilitate discussions on Tires 1 and 3 of Job(01)/152/Rev.1, the Secretariat was requested to prepare a background Note on the factors and elements taken into account by the IMF in its determination of what constitutes a serious decline in a country's monetary reserves, a very low level of its monetary reserves or a reasonable rate of increase in its monetary reserves, and as to the financial aspects of other matters covered in consultations with the country by the IMF in such cases. It was requested to pay particular attention to how the determinations by the IMF, and the criteria used by them for assessing the adequacy of foreign exchange reserves, had been affected by the financial crises witnessed in the last few years, and by the changing nature of the external vulnerability of developing countries, in particular the volatility of capital flows, and the requirements to secure consistency between policies regarding the current and the capital account. It was asked to describe how these determinations and criteria helped meet the requirements of the *proviso* and the *Ad Note* to GATT Article XVIII:11.

II. THE ROLE OF THE IMF IN THE CONSULTATIONS OF THE COMMITTEE ON BALANCE-OF-PAYMENTS RESTRICTIONS

3. The role of the IMF in the consultations of the Committee on Balance-of-Payments Restrictions (BOPs Committee) is set out in GATT Article XV:2 and GATS Article XI:5(e). Both Articles require the BOPs Committee to accept "... all findings of statistical and other facts presented by the IMF relating to foreign exchange, monetary reserves and balance-of-payments". In addition, in the case of GATT Article XV, the IMF is asked to provide a determination "as to what constitutes a serious decline in the [consulting] contracting party's monetary reserves, a very low level of its monetary reserves, or a reasonable rate of increase in its monetary reserves, and as to the financial aspects of other matters covered in consultation in such cases". In the case of GATS

¹ WT/BOP/R/63, paragraph 4.

Article X11:5(e), the BOPs Committee shall base its conclusions "... on the assessment by the Fund of the balance-of-payments and the external financial situation of the consulting country".

4. The IMF has regularly provided information to the BOPs Committee on each consulting country's recent economic developments, focusing in particular on macroeconomic indicators that are linked to the country's current and prospective balance-of-payments situation. This has been used extensively in the BOPs Committee's discussions on the parts of its consultation dealing with "balance-of-payments position and prospects" and "alternative measures to restore equilibrium", which in turn has been an important input to the Committee's consideration of the justification for the institution, maintenance, or intensification of trade restrictions for balance-of-payments purposes.

5. The IMF is not asked to contribute directly to the BOPs Committee's assessment of the justification for trade restrictions, nor is it asked to comment on the matters covered by the *proviso* and the *Ad Note* to GATT Article XVIII: 11.

A. IMF CONTRIBUTIONS TO CONSULTATIONS OF THE BALANCE-OF-PAYMENTS COMMITTEE: 1970-2001

6. Between 1970 and 2001, the BOPs Committee conducted 224 consultations with Member countries. Reports of these consultations are contained in the document series BOP/R/--, and since 1995 in the series WT/BOP/R/--. Most of those consultations have been held under the Committee's full consultation procedures, for which the IMF has contributed both a statement, which is reproduced in full in the Committee's reports, and its own consultation report on recent economic developments in the consulting country.

7. The IMF statement to the BOPs Committee has regularly covered the following factors:

- recent developments in the real sector of the economy (e.g., investment, aggregate demand, output, growth and inflation);
- how developments in the real sector relate to the financial sector and to the macroeconomic situation, in particular the IMF's assessment of the internal macroeconomic imbalance that is causing the balance-of-payments problem focusing on fiscal, monetary, and exchange rate policies;
- the current and prospective balance-of-payments position, focusing on the trade and current accounts, and since the early-1980s on capital account developments too;
- a description of the trade and exchange restrictions in place, and of any steps being taken to intensify or liberalize them;
- information on the consulting country's relations with the IMF, in particular whether an IMF programme is in place or under negotiation.

8. The IMF has included in its statement, where applicable, reference to external factors affecting adversely the consulting country's balance-of-payments situation and prospects. Examples have been the effects of the energy crisis of the 1970s, and more generally overseas trade barriers and changes in the terms of trade on a consulting country's import prices and export earnings. It has typically reviewed these factors in the context of their effect in weakening the consulting country's balance-of-payments situation, in creating more uncertain balance-of-payments prospects, and in some cases in justifying more time to phase-out trade restrictions for balance-of-payments purposes.

9. The IMF has also included in its statement, where applicable, information on the consulting country's level of foreign debt and its foreign debt service obligations. This became a regular feature

of IMF statements from the late-1970s, as a larger number of consulting countries gained access to international capital markets and raised their levels of foreign borrowing. The IMF has provided information on gross and net international monetary reserves, and where applicable it has drawn attention to the relative importance of short-term foreign debt in a consulting country's overall foreign debt profile. This has been placed in the context of the country's balance-of-payments adjustment policies and financing needs, and has been described in terms of the relative importance of foreign borrowing in bolstering the level of monetary reserves and in creating offsetting foreign exchange liabilities.

10. The IMF statement has regularly provided statistics and other information on the consulting country's level of monetary reserves, usually expressed in value terms, often also in terms of equivalent months of import cover, and sometimes in relation to the total size of external transactions. This information has been presented typically in the context of the expected evolution of the consulting country's balance-of-payments and foreign debt situation, in particular whether the balance-of-payments is expected to continue to deteriorate and place pressure on the level of reserves or to start improving, whether accumulated foreign liabilities are placing the level of monetary reserves under pressure, and whether further foreign borrowing presents a viable and sustainable option to finance the balance-of-payments and bolster the level of monetary reserves. The static picture of reserve holdings and adequacy has therefore been combined in the IMF statement with a dynamic assessment of expected changes in reserve holdings.

11. Many countries consulting in the BOPs Committee have held monetary reserves equivalent to about 3 months of import cover. In their own statements to the BOPs Committee, these countries sometimes referred to this level of monetary reserves as the minimum level which their monetary authorities regarded as prudent. Some consulting countries have held much lower levels of monetary reserves at the time of their consultation in the BOPs Committee, in certain cases equivalent to less than 1 month's import cover, while others have held much higher levels of monetary reserves; reserve holdings of 6-7 months of import cover have not been unusual, and in some cases monetary reserves stood at 11-12 months of import cover at the time of the BOPs consultation. There is some evidence of consulting countries wishing to hold a higher level of monetary reserves in the 1990s than in the 1970s and 1980s, in light of their concern about the volatility of capital flows following periods of financial crisis. However, the evidence is not overwhelming, in part perhaps because the countries concerned were not, by and large, emerging market economies that were vulnerable to large inflows and outflows of speculative foreign capital.

B. IMF STATEMENTS IN THE 1970S

12. Most IMF statements in the 1970s drew a direct link between the consulting country's level of monetary reserves and its use of trade restrictions for balance-of-payments purposes. Generally, the IMF followed closely the language contained in GATT Article XV:2 and referred to whether the trade restrictions under consideration in the BOPs Committee did or did not go beyond the extent necessary to stop a serious decline or to achieve a reasonable rate of increase in the level of monetary reserves.

13. There was no clear correlation between any specific level of monetary reserves (3 month's import cover, for example) and the IMF's conclusion on the use of trade restrictions. In most cases, a low level of monetary reserves corresponded to the IMF's assessment of a weak balance-of-payments situation in the consulting country and led it to conclude that "trade restrictions in effect do not go beyond those necessary to prevent a decline in monetary reserves" or "trade measures are not unwarranted".

14. However, there were a significant number of instances in which that correspondence did not hold. In some cases the IMF noted that notwithstanding a low level of monetary reserves the consulting country's balance-of-payments situation was strengthening and was expected to continue to do so, and it encouraged the country to begin or to accelerate the liberalization of its trade restrictions

maintained for balance-of-payments purposes. In some others, notwithstanding a high level of monetary reserves, the IMF pointed to an expected weakening of the balance-of-payments situation and concluded that the country concerned was justified in continuing to apply trade restrictions for balance-of-payments purposes. In some cases, the IMF placed the liberalization of trade restrictions in a broader context of the consulting country's investment and economic development programme.

15. Examples of conclusions in IMF statements in the 1970s illustrating these points are:

- "The gross international reserves of the banking system although low, are adequate to sustain current trade and payments needs."
- "While the current level of gross international reserves would not appear to be a constraint towards continuing on the path of planned import liberalization, it cannot be considered excessive in the light of expected current account developments. In view of the above the remaining restrictions in effect do not go beyond that necessary to prevent a decline in monetary reserves." (Gross reserves were over 4 month's import cover)
- "The relatively favourable balance-of-payments prospects should be seen against the background of a steady decline in recent years in the level of gross official reserves as a proportion of imports. The Fund would welcome further progress towards easing restrictions on trade and payments. In the meantime, the Fund considers that the overall restrictiveness of [the] import regime does not go beyond what is necessary to prevent a decline in international reserves." (Gross reserves stood at 6 week's import cover)
- "At present, the overall balance-of-payments position continues to be strong and international reserves are high, and there appears to be scope for continuation of the recent trend towards liberalization. An appropriate balance between policies to increase investment and measures to reduce further import protection would improve productive efficiency, reduce domestic shortages, and promote economic development." (Gross reserves were at 10 month's import cover).

16. In only one instance in the 1970s did the IMF conclude that the use of trade restrictions for balance-of-payments purposes was no longer justified. In that case, the level of monetary reserves stood at 10 months of import cover. It concluded:

- "The Fund believes that in view of [the] balance-of-payments and reserve position, restrictions on imports can no longer be justified on balance-of-payments grounds."

C. IMF STATEMENTS IN THE 1980S AND 1990S

17. IMF statements and supporting documentation in the 1980s and 1990s continued to provide extensive information on recent developments in the real sector of each consulting country's economy, on the stance of its macroeconomic policies, and on its balance-of-payments position and prospects. They provided information on trade restrictions and exchange restrictions in place. By the mid-1980s, many consulting countries had had trade restrictions for balance-of-payments purposes in place for five or more years. The IMF statement began regularly to draw attention to the fact that these measures alone could not be expected to restore balance-of-payments equilibrium, and pointed to their cumulative adverse effects on resource allocation.

18. IMF statements provided information, where applicable, on external factors affecting a consulting country's balance-of-payments situation and prospects. Overseas market access barriers and changes in the terms of trade continued to be highlighted by the IMF where relevant. In addition, it drew attention in some cases to the importance of increased concessional lending by a consulting country's development partners in helping to finance the current account of the balance-of-payments.

19. IMF statements regularly provided information on a consulting country's level of monetary reserves, placing this in the context of the balance-of-payments situation and prospects and the sustainability of current levels of foreign debt. The foreign debt situation of many consulting countries became an increasingly prominent feature of IMF statements. In addition to providing data on the debt situation, including on the maturity profile of foreign debt, the IMF factored foreign debt liabilities into its balance-of-payments projections for a consulting country. Where the current balance-of-payments situation, including the level of monetary reserves, was affected by potentially volatile movements in short-term capital, the IMF pointed this out. In some cases, the IMF emphasized the importance of cooperative contributions by private lenders to an orderly work-out of a country's foreign debt problem.

20. Since the early 1980s, the IMF statements have no longer drawn a direct link between the level of monetary reserves and the use of trade restrictions for balance-of-payments purposes. Instead, the conclusion of the IMF statement has focused on the availability and adequacy of alternative measures to restore balance-of-payments equilibrium, and related this, rather than the level of monetary reserves, to the continued use of trade restrictions. In this regard, for example, in cases where a build-up of foreign debt to unsustainable levels has been a feature of the IMF's analysis of a consulting country's balance-of-payments situation, it has focused on the importance of alternative adjustment measures to restore balance-of-payments equilibrium and has not viewed debt servicing difficulties as a reason for prolonging the maintenance of trade restrictions.

21. A typical conclusion to IMF statements in the 1980s and 1990s has been: "Trade restrictions may be warranted on a temporary basis while more fundamental adjustment measures take effect". Or, in cases where the prospect is for a consulting country's balance-of-payments situation to improve on the basis of alternative adjustment measures: "There is scope for resuming/accelerating the removal of trade restrictions".

22. Examples of conclusions in IMF statements between 1980 and 1995 are:

- "Notwithstanding a sizeable increase in external borrowing, the overall balance deteriorated significantly and gross official foreign exchange reserves declined to the equivalent of less than 3 weeks imports. The Fund hopes that the improvement in the current account that would be fostered by the pursuit of a tighter policy stance would allow a more liberal administration of import licences and establish the basis for a gradual reduction of trade restrictions."
- "While [the level of official reserves] represents a relatively high proportion of imports, [it] must be seen against the background of some special factors of uncertainty, considerable dependence on short-term capital inflows, and a relatively large amount of external debt. The Fund hopes that the authorities, by strengthening the adjustment effort, will be better placed to further liberalize the exchange and trade system."
- "The Fund believes that the projected improvement in the external current balance and the expected availability of financing from official and private sources as confidence on the part of foreign private lenders recovers should make it possible to increase holdings of reserves, while permitting the removal of the import restrictions."
- "The Fund believes that with a determined adjustment programme and the support and cooperation of the international financial community, conditions will have been created for the restoration of a liberal trade and payments system."
- "Adjustment efforts will need to continue over the medium-term, and a significant increase in concessional external assistance from bilateral and multilateral sources would

contribute to the success of such efforts. As the economic recovery takes hold, the authorities would be in a better position to ease exchange and trade restrictions."

- "The Fund believes it would be unfortunate if the attainment of ... growth and external objectives were to be obstructed by the imposition of trade barriers in its export markets. The Fund welcomes ... progress towards relaxation of restrictions and hopes that, with the continued pursuit of appropriate economic policies and the cooperation of its trading partners, the liberalization process can be further accelerated."
- "The Fund welcomes the efforts being made by the authorities to address economic and financial imbalances, and hopes that these adjustment efforts will be continued to allow for a further liberalization of the exchange and trade system."
- "[the] comprehensive adjustment programme provides the basis for a major liberalization of the restrictive trade and payments system; the Fund has emphasized the need to implement the planned measures on schedule, and has stressed the importance of taking further measures to liberalize the trade and payments system."
- "Given that the medium-term outlook of the economy and of the balance-of-payments remains extremely difficult, the Fund urges the authorities to undertake a strong and comprehensive adjustment programme with greater action at an early stage. Such a programme could prepare the ground for the achievement of sustainable economic growth, lower inflation, viability of the balance-of-payments over the long term, and the elimination of exchange and trade restrictions."
- "The steady implementation of [adjustment] policies will strengthen the underlying balance-of-payments position and thus permit a further reduction in the restrictiveness of the exchange and trade system. To be effective, however, they will need to be complemented by adequate aid flows and unhampered access to foreign markets."

D. IMF STATEMENTS SINCE 1995

23. Since the entry into force of the WTO, the BOPs Committee has held 21 full consultations with 13 Members. IMF statements and supporting documentation have covered much the same ground as in the 1980s and 1990s, and the same factors would appear to have been taken into account by the IMF in its assessment of the level of monetary reserves and the financial aspects of other matters covered in the BOPs Committee's consultations. Where applicable the IMF has provided a comprehensive description of a consulting country's debt profile and debt service obligations, and related this to the balance-of-payments prospects and the adequacy of the level of monetary reserves. In its conclusions, the IMF has focused, in particular, on the adequacy of alternative measures to restore balance-of-payments equilibrium.

(i) *Consulting Member: Hungary*²

24. Hungary consulted in the BOPs Committee in 1995 and 1996.

25. At the 1996 consultation, the IMF noted that the fiscal and external current account deficits had declined sharply, structural reform had gained momentum, and stronger external performance had facilitated a sizeable decline in net external debt. A surge in direct investment and other private capital inflows had boosted gross official reserves to a level equivalent to 9½ months of import cover at end-1995. The improvement in the balance of payments had continued in 1996, but official reserves had declined because of early repayments of official debt and the relocation abroad of some

² WT/BOP/R/3 and R/17.

of the foreign exchange deposits held by commercial banks. However, this development has no implications for the underlying external position, and at end-June reserves stood at the still comfortable level of about 8 months of import cover. The IMF concluded:

"In summary, the adjustment program undertaken since early 1995 has yielded important results in terms of macroeconomic stabilization. Most notably, the external position has strengthened substantially over the last eighteen months and the objective of containing the current account deficit to less than US\$2 billion in 1996 appears feasible. The recent reduction in the import surcharge ahead of the original schedule is welcome. Furthermore, the authorities' continued commitment to fiscal consolidation and structural reform bodes well for 1997, and should facilitate the elimination of the import surcharge by July 1997."

(ii) *Consulting Member: Slovak Republic*³

26. The Slovak Republic consulted in the BOPs Committee in 1995, 1996, 1997, 1999 and 2000.

27. At the 1996 consultation, the IMF noted that Slovakia had made significant progress in its economic management and performance, and that it was continuing to liberalize its current and capital account transactions. The balance-of-payments had strengthened in 1995, and foreign currency reserves had increased to a level equivalent to 4.4 months of import cover. The main development in 1996 had been an unexpectedly large and rapid turnaround in the current account, reflecting mainly continued high import growth, while exports stagnated. The IMF noted that Slovakia had a substantially liberalized trade system, but continued to maintain a 10 per cent import surcharge on consumer goods, which had been imposed in 1994 to deal with a temporary deterioration of the external accounts. The authorities had delayed the elimination of the surcharge, mainly because of balance-of-payments concerns. The IMF maintained that financial policies, rather than the import surcharge, were the most appropriate tools to respond to balance-of-payments difficulties. The IMF concluded as follows:

"To conclude, the Slovak authorities have made important progress in the transition to a market economy. Tighter financial policies and further structural adjustment are needed to consolidate these achievements, and to ensure a more robust external position. The Fund regrets the Slovak authorities' decision not to phase out the import surcharge in 1995 when the situation was especially propitious. It urges the authorities to reconsider their decision by beginning to phase out the surcharge immediately with a view to its prompt elimination."

28. At the 1997 consultations, the IMF noted that a large current account deficit had emerged in 1996 and persisted in 1997. Macroeconomic attempts to correct this had been undermined by lax fiscal policy. Reserve cover had fallen gradually to less than 3½ months of import cover. It noted that in May 1997, the Slovak Crown had faced a speculative attack, precipitated in part by the contagion effects from the turmoil in the Czech exchange market, but also against the background of the large current account deficit. Slovakia maintained a substantially liberalized trade regime. The original import surcharge had been replaced in May 1997 by an import deposit scheme, which in turn was replaced in July 1997 by another import surcharge. The authorities had announced the import surcharge would be temporary, steadily phased out, and eliminated at end-1998. The IMF concluded:

³ WT/BOP/R/4, R/15, R/40, R/48 and R/52.

"In consultations with Slovakia, the Fund has urged the authorities not to impose trade restrictions and to rely instead on an appropriate mix of macroeconomic policies to deal with the large external imbalance. The surcharge cannot be a substitute for appropriate fiscal tightening to reduce the external deficit to a sustainable level. The Fund urges the authorities to immediately tighten fiscal policy and to initiate the phased removal of the surcharge, preferably ahead of the announced schedule."

29. At the 1999 consultations, the IMF noted that notwithstanding a large external imbalance, fiscal and monetary policy had been expansionary in 1998. With only modest foreign direct investment, the persistence of large external current account imbalances had resulted in an exceptionally rapid increase in Slovakia's external indebtedness to about 60 per cent of GDP at end-1998. About 40 per cent of this was short-term debt. The currency had come under strong pressure, and international reserves had been reduced to an uncomfortably low level of 2½ months of import cover, equivalent to 49 per cent of short-term external debt.

30. Fiscal policy had been tightened in 1999, sufficiently to be instrumental in bringing about a halving of the external current account deficit. In addition, reflecting their balance-of-payments concerns, the authorities had decided to improve an import surcharge of 7 per cent, to be reduced over time and phased out by the end of 2000. The new fiscal package has contributed to favourable developments in financial markets. Foreign exchange inflows had helped replenish international reserves, which had risen to 2.3 months of import cover, equivalent to 79 per cent of short-term external debt, but the IMF expected international reserves to remain at an uncomfortably low level in 1999. The IMF concluded:

"In its consultations with Slovakia, the Fund has indicated its regret over the imposition of the import surcharge – preferring additional fiscal expenditure cuts instead – and continues to urge the authorities to phase out the import surcharge quickly. Staff has stressed that while an import surcharge is an instrument that countries have on occasion resorted to when they faced balance-of-payments and fiscal problems, its introduction distorts international trade and undermines efficiency and longer-run adjustment. Thus, if the authorities insisted on introducing a surcharge, staff urged them, consistent with Fund advice to other member countries, to keep the surcharge low (24 per cent) and to eliminate it quickly (within 6-9 months of its introduction) according to a pre-determined phase-out schedule, with the time being used to strengthen expenditure consolidation. In concluding the Article IV Consultation with the Slovak Republic on July 21, 1999, Executive Directors of the Fund also expressed regret over the imposition of the surcharge, and urged that it be phased out quickly."

31. At the consultation in 2000, the IMF statement noted that Slovakia had made significant progress in stabilizing the economy and accelerating structural reform. There had been a considerable easing of balance-of-payments difficulties. The current account deficit was halved in 1999, and had narrowed further in 2000. Official international reserves at end-August 2000 reached the equivalent to 3.6 months of import cover, boosted by borrowing abroad. The IMF concluded:

"The authorities have adhered to their proposed timetable for the elimination of the import surcharge, reducing it from 7 per cent to 5 per cent in January 2000 and to 3 per cent in July 2000. Their intention is to eliminate the surcharge by January 1, 2001. The Fund had indicated its regret over the imposition of the import

surcharge-having preferred additional fiscal expenditure cuts instead and strongly supports its removal."

(iii) *Consulting Member: Brazil*⁴

32. Brazil consulted in the BOPs Committee in 1995.

33. In its statement, the IMF noted that successful implementation of the *Real Plan* had left Brazil's current account roughly in balance in 1994 and the overall balance-of-payments with a surplus, reflecting in part large inflows of portfolio and other short-term foreign capital. Beginning in late-1994, the overall balance-of-payments had deteriorated and moved into deficit, reflecting the expansion of domestic demand, the effect of trade liberalization measures, and the real appreciation of the currency, as well as capital outflows associated with the Mexican crisis. On the basis of current policies, the overall balance-of-payments was expected to register a surplus in 1995 on account of renewed inflows of capital, but, the IMF noted, the implied build-up in international reserves was dependent on the behaviour of portfolio flows, which had shown sizeable swings during 1995. Gross international reserves had declined as a result of the deteriorating trade balance and large capital outflows in the wake of the Mexican crisis, but the decline stopped in the second quarter as capital inflows resumed, and reserves increased at end-August 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, had prompted large foreign portfolio investment and foreign borrowing by Brazilian residents. In response to the strong capital inflows, the authorities had raised taxes on investment by foreigners in fixed-income instruments and on bond placements abroad, and had 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. The IMF concluded as follows:

"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 stabilisation from monetary policy. 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."

(iv) *Consulting Member: Sri Lanka*⁵

34. Sri Lanka consulted in the BOPs Committee in 1995.

⁴ WT/BOP/R/7.

⁵ WT/BOP/R/8.

35. In its statement, the IMF noted that Sri Lanka's economic performance had been adversely affected since mid-1994 by policy slippages. Developments in the balance-of-payments reflected the deterioration in the economic situation, which had its roots in a large fiscal deficit and rapid credit expansion. Until late-1994, Sri Lanka had experienced unprecedented foreign inflows, including sizeable aid flows, large remittances from overseas workers, and foreign direct and portfolio investment. These inflows led to overall balance-of-payments surpluses and allowed a significant increase in gross official reserves to about 5 months of imports. However, the overall balance shifted to a deficit in the first seven months of 1995, reflecting both a large current account deficit and a slowing of private capital inflows. Reserves had fallen to 4½ months of import cover. External prospects were uncertain for the remainder of 1995 and 1996. The IMF concluded as follows:

"In conclusion, achievement of Sri Lanka's long-term objective of poverty elimination through high levels of sustainable growth will depend on structural improvements and macroeconomic stability. The recent deterioration in the balance of payments will be arrested on an enduring basis only by a substantial strengthening of the public finances. In this regard, licensing restrictions on selected agricultural products will do little to correct the fundamental macroeconomic imbalances, while distorting resource allocation. Developments thus far in 1995 suggest that progress toward Sri Lanka's long-term objectives will be delayed. For 1996, the authorities need to take steps to formulate a budget and to frame a complementary monetary policy, that could accompany an aggressive programme of structural reform, including the timely elimination of the remaining import licensing restrictions."

(v) *Consulting Member: India*⁶

36. India consulted in the BOPs Committee between 1995 and 1997.

37. At the 1995 consultation, the IMF pointed to India's fiscal situation and its need for structural reform as two major areas of concern relating to its balance-of-payments situation, and to India meeting its full growth potential. It noted that foreign exchange reserves were equivalent to around 6½ months of import cover. Factors behind the build-up in reserves were a surge in private capital inflows following the liberalization of restrictions on inward foreign investment and the resumption of rapid export growth. The scale of portfolio inflows had subsided since late-1994, consistent with a general reappraisal of emerging markets by investors in the wake of the Mexico crisis, but foreign direct investment had continued to increase. With continued prudent macroeconomic management, India's medium-term balance-of-payments prospects looked sound. In view of heavy investment needs, the current account deficit was expected to widen further, but this should be sustainable in view of the improved prospects for private capital inflows, including direct investment. The debt-service ratio would be lowered to under 20 percent by the end of the decade, while international reserves would be maintained at comfortable levels.

38. The IMF's conclusions with respect to trade restrictions were:

"On the external front, the process of trade liberalization needs to be completed. Tariff levels are still high and need to be brought down further. Even more important, the quantitative restrictions on imports of consumer goods need to be eliminated, and replaced by tariffs at moderate levels. Excessive protection has hindered the development of this important sector of the economy. Some phasing of this

⁶ WT/BOP/R/11, R/22 and R/32.

process may be appropriate in view of recent exchange market pressures, the potential volatility of private capital inflows, and the need to provide adequate time for adjustment of certain domestic industries. Nevertheless, the transition to a tariff-based import regime with no quantitative restrictions could reasonably be accomplished within a period of two years."

39. At the first consultation in 1997, the IMF noted that after several years of surplus India's balance-of-payments had moved into deficit in 1995/96. The current account deficit had widened as rapid import growth related to rising domestic demand more than offset a continued strong export performance. While portfolio equity inflows had slowed, direct investment continued to rise. The authorities had responded to several episodes of downward pressure on the exchange rate through intervention supported by steps to tighten liquidity, while taking administrative measures to discourage speculative activities. Since February 1996, exchange market pressures had eased as import growth slowed and private capital inflows strengthened. Against this background, the Reserve Bank of India had been able to replenish international reserves in advance of large amortization payments that fell due in early 1997. Gross international reserves were expected to increase by year-end to a comfortable 5 months of imports, a level that was sizeable also in comparison to the stock of short-term debt and the cumulative stock of portfolio equity inflows.

40. Looking to the medium-term, the current account deficit was likely to continue to widen, reflecting the impact of rising infrastructure investment and continued trade liberalization, notwithstanding good prospects for exports as the economy became more open. Private capital inflows should remain buoyant, with rising foreign direct investment complementing portfolio flows and external borrowing. Further capital account liberalization would contribute to fostering such inflows, with priority being given to direct and portfolio investment. Provided that macroeconomic policy was prudent, this outlook should be fully consistent with continued external viability. Indeed, a gradual rise in the current account deficit up to 3-4 per cent of GDP would still be compatible with bringing the debt service ratio to well under 20 per cent over the next few years. However, caution would be needed to avoid progressing too far along the path of increased reliance on foreign savings until fiscal consolidation was well advanced.

41. The IMF's conclusions were:

"Trade reform should also be a particular priority. Substantial progress has been made over the past five years, reflected in a lowering of the average import-weighted tariff from 87 per cent in 1990/91 to under 23 per cent in 1996/97. Nevertheless, tariffs remain high by East Asian standards, and – notwithstanding some recent progress – quantitative restrictions (QRs) still cover most of the consumer goods sector. While the lowering of tariffs on raw materials and intermediate products in the 1996/97 budget was welcome, one implication is that the already high effective rates of protection for the consumer goods sector have increased. Early action and a clear timetable for removing the continuing QRs on consumer goods imports – together with liberalization of the system of reservation for small-scale units of many manufactured products – would help reduce distortions to investment incentives and encourage the emergence of an efficient, export-oriented consumer goods industry. Moreover, in the Fund's judgement, the external situation can be well managed using macroeconomic policy instruments without recourse to QRs. The Fund's view, therefore, is that QRs should be removed over a relatively short period; the tariff levels applied to previously restricted consumer goods imports could

initially be kept close to the top end of the existing tariff structure, but tariffs should be scaled back gradually over a pre-set timetable."

42. When consultations resumed later in 1997 to consider India's phase-out plan, the IMF noted that its overall assessment of India's economic performance remained broadly unchanged. The balance-of-payments had recorded a sizeable surplus in 1996/97 while the current account deficit remained around 1½ per cent of GDP. There had been a sharp slowdown in export growth, but import growth had also slowed significantly. Meanwhile, there were strong inflows of private portfolio investment and direct foreign investment. Gross official reserves had increased to about 6 months of import cover. For 1997/98, the balance-of-payments was expected to register another sizable surplus. The current account deficit was projected to widen, but strong private capital inflows were likely to continue. Gross official reserves were expected to rise further to about 6½ months of import cover.

43. Over the medium-term, the current account deficit was likely to continue to widen as infrastructure investment accelerated. Further capital account liberalization should encourage private capital inflows, and emphasis should be placed on promoting further portfolio investment and foreign direct investment. With continued prudent macroeconomic policies – and especially significant fiscal adjustment – a current account deficit rising to 3-4 per cent of GDP would be consistent with the authorities' target of maintaining a debt service ratio below 20 per cent.

44. The IMF's conclusions were:

"Some further progress has also been made with trade liberalization in recent months. With the lowering of import duties in the 1997/98 budget, the peak duty rate is now 40 per cent and the average (import-weighted) duty rate is slightly above 20 per cent. However, the 2 per cent import surcharge is still in place, while duty rates still remain high by East Asian standards. Moreover, while the recent Export-Import Policy for 1997-2002 moved about one sixth of the remaining number of items off the restricted import list, quantitative restrictions (QRs) still cover a significant part of the consumer goods sector. A time-bound programme for eliminating the remaining QRs would reduce distortions to investment and promote an efficient, export-oriented consumer goods industry. It remains the Fund's view that the external situation can be well managed using macroeconomic policy instruments alone; QRs are not needed for balance of payments adjustment and should be removed over a relatively short time period. The tariffs applied to previously restricted consumer good imports could initially be kept close to the top of the existing tariff structure, but should be gradually scaled back according to a pre-set timetable."

(vi) *Consulting Member: Nigeria*⁷

45. Nigeria consulted in the BOPs Committee in 1996 and 1997.

46. At the 1996 consultation, the IMF cited excessively expansionary fiscal and monetary policies and inappropriate management of the exchange rate as major contributing factors to Nigeria's balance-of-payments weakness, and noted that these were exacerbated by a weakening of the terms of trade. It noted that gross foreign exchange reserves were low (1.4 months of import cover in 1995 and 2.9 months of import cover in 1996). It noted also that substantial external payments arrears had accumulated already and were continuing to do so, that Nigeria's external debt service burden was

⁷ WT/BOP/R/13, R/18 and R/25.

heavy, and that these together had created an external sector imbalance of major proportions. The IMF's conclusions in 1996 were:

"Pending implementation of a comprehensive adjustment program, Nigeria's external prospects in the short and medium term remain precarious, owing to its heavy debt service burden, weak performance of the non-oil export sector, and uncertainty regarding the future course of oil prices. It would be essential that a bold and credible program of measures be undertaken, including unifying the dual exchange rates, accelerating privatization and public enterprise reforms, and liberalizing the trade regime. The Fund staff continues to be of the view that the steadfast implementation of strong macroeconomic policies, rather than resort to trade restrictions, is necessary to achieve lasting improvements. The Fund staff encourages the early unification of the exchange rates and the adoption of a specific timetable for the elimination of trade and exchange restrictions."

47. At the 1997 consultation, the IMF noted that corrective measures applied by Nigeria in 1995 and 1996 had had some success in restoring macroeconomic stability. The current account had been improving, and gross international reserves were reported to have increased to 5.2 months import cover. On the basis of projections that oil prices would remain relatively high, the current account was projected to remain in surplus over the medium-term, but the capital account was projected to remain in deficit. Nigeria's economic prospects therefore remained fragile. The Fund concluded as follows:

"In the Fund's view, trade and exchange restrictions are not the appropriate means to tackle the balance-of-payments problem. Accordingly, the [IMF] Executive Board did not approve the maintenance of exchange restrictions nor the maintenance of the multiple currency practice arising from the current dual exchange rate system. Rather, the Board maintained that the steadfast implementation of strong macroeconomic policies was required if improvements in the overall balance-of-payments were to be sustainable. The authorities should, without delay, remove prohibitions on exports and imports, as well as all remaining restrictions on current international transactions."

(vii) *Consulting Member: Tunisia*⁸

48. Tunisia consulted in the BOPs Committee in 1996 and 1997.

49. In its 1996 statement, the IMF noted that the weakening of Tunisia's budget position had contributed to pressures on the external accounts in 1995. The overall balance-of-payments had moved into deficit, and gross official reserves were estimated to have fallen to about 2 months of import cover by mid-1996. The IMF concluded as follows:

"In conclusion, the Fund commends the authorities for the sustained implementation of sound demand management policies and structural reforms. The staff agrees with the authorities' approach to aim at higher growth over the medium term by fostering a market-based, open, and private sector driven economy, while consolidating

⁸ WT/BOP/R/14 and R/31.

macroeconomic stability. The authorities in particular need to be ready to take appropriate action to meet the fiscal target for 1996, in order to contain the balance-of-payments pressures that have emerged, and to achieve their external targets. This strategy should contribute to the rapid development of the country, the strengthening of the external position, and the further integration of Tunisia's goods, services, and financial markets into the world economy. The Fund encourages the authorities to promptly eliminate all remaining trade restrictions maintained for balance-of-payments purposes."

50. In its 1997 statement, the IMF noted that the current account deficit had narrowed in 1996. Higher public borrowing from capital markets more than offset a temporary shortfall in grants, and the overall balance-of-payments registered a surplus which brought gross official foreign exchange reserves to the equivalent of 3.2 months of import cover by year-end. Since then, reserves had declined to 2.5 months of import cover, reflecting seasonal factors and the timing of foreign borrowing. The balance-of-payments outlook for 1997 was encouraging. Maintaining the current account deficit at 3 per cent of GDP while stabilising reserves at the equivalent of 3.2 months of import cover appeared feasible. The IMF concluded as follows:

"In conclusion, the Fund commends the Tunisian authorities for maintaining macroeconomic stability while pursuing structural reforms. The Fund welcomes the authorities' intention to direct the medium-term strategy underlying the IXth Economic Development Plan toward fostering a market-based, open, and private sector driven economy, while consolidating macroeconomic stability. This strategy should also contribute to the further integration of Tunisia's goods, services and financial markets into the world economy. In this regard, the Fund encourages the authorities to promptly eliminate remaining quantitative trade restrictions maintained for balance of payments purposes."

(viii) *Consulting Member: Pakistan*⁹

51. Pakistan consulted in the BOPs Committee in 1997 and 2000.

52. At the 1997 consultation, the IMF noted that Pakistan's balance-of-payments continued to be characterised by a large current account deficit, heavy reliance on short-term financing, and a relatively weak external reserve position. The net foreign asset position of the central bank deteriorated markedly, including a decline in gross official reserves to 3.6 weeks of import cover. The government had embarked on a consolidation and intensification of structural reforms and adjustment efforts, including a re-enforcement of the macroeconomic stabilization effort and structural reforms in the tax system, in the financial sector, and in the non-financial public sector. On the fiscal side, this included tariff reform. If implemented on a timely basis, the policy package was projected to contribute to contain the external current account deficit at about the same level as in 1995/96, and gross official reserves would recover to about 5 weeks of import cover, notwithstanding scheduled debt service payments. The IMF concluded as follows:

"The implementation of the new government's reforms initiatives would constitute a substantial and much needed change in the structure of the economy. The reforms would provide a firm basis for further efforts to enhance the growth potential of the Pakistan economy, eliminate chronic structural weaknesses, and improve the

⁹ WT/BOP/R/27 and R/51.

inflation and balance of payments performance. There are, however, downside risks. First, the external outlook remains fragile and the economy is very vulnerable to unfavourable changes in market sentiment. Second, the wide range of the proposed reforms will put a strain on the country's implementation and administrative capacity. Third, it is critical that the package of reforms be implemented fully and on a timely basis. In particular, any slippage in the broadening of the bases of the affected taxes would lead to revenue losses that would need to be immediately compensated by further fiscal efforts. In view of these risks, Fund staff has stressed to the authorities the importance of determined policy implementation and high responsiveness of the policy stance to changes in market sentiment."

53. At the consultations in 2000, the IMF noted that the trade account was projected to improve significantly despite a sharp deterioration in the terms of trade, because of strong growth in export volumes. The current account deficit was expected to decline, and taking into account developments in the capital account foreign exchange reserves were projected to amount to about 3.7 weeks of import cover. The IMF concluded:

"Pakistan needs to achieve high and sustainable economic growth to reduce the internal and external imbalances in the economy. This will require prudent demand management policies, a private investment friendly environment, and a bold structural reform program. The new government's reform agenda and commitment to improve public finances are encouraging and should be implemented vigorously. In the near term, however, the external outlook will remain fragile and financial support from the international community will be critical. This support, in turn, will hinge on the government's ability to start implementing a strong and credible programme of economic reform, including steps to enhance transparency and governance."

(ix) *Consulting Member: Czech Republic*¹⁰

54. The Czech Republic consulted in the BOPs Committee in 1997.

55. The IMF noted that recent economic developments have been characterized by growing macroeconomic imbalances, which eventually culminated in disorderly conditions in the foreign exchange market in late May 1997, including massive speculative pressures on the exchange rate and capital outflows. The Czech authorities had announced fiscal, wage and structural reform policy measures to address the imbalances. The outlook was for a modest narrowing of the external imbalance in 1997-98. There had been a positive response of portfolio inflows to capital market reforms, and the deficit should be financeable through a combination of debt and non-debt creating capital inflows and, in 1997, a drawdown of reserves. Official reserves amounted to about 3½ months of import cover and were expected to remain at a satisfactory level in relation to imports and to short-term debt. The IMF concluded:

"In April 1997, the Czech authorities introduced an import deposit scheme, which is administered through the import system, applies to consumer goods and foodstuffs (about 30 per cent of total imports), and requires a six-month non interest-bearing deposit equal to 20 per cent of import value. It was originally intended to remain in effect for

¹⁰ WT/BOP/R/33.

about a year. According to IMF staff estimates, the scheme is likely to raise the cost of affected imports by about 1½-2 per cent on the assumption that the deposited amount will be borrowed from banks; however, this does not take into account liquidity constraints and administrative costs that especially affect small importers. The Fund's view is that this measure – much like other administrative measures to reduce imports – is overly complex, has distortionary effects and is not a substitute for macroeconomic policy action to correct the economic fundamentals. Rather, macroeconomic policy corrections should be introduced as soon as possible, so as to facilitate the early removal of the import deposit scheme."

(x) *Consulting Member: Bulgaria*¹¹

56. Bulgaria consulted in the BOPs Committee in 1997 and 1998.

57. At the 1997 consultation, the IMF noted that Bulgaria had joined the WTO in the midst of a rapidly worsening economic and financial crisis rooted in heavy internal and external indebtedness and financial indiscipline in the banking and enterprise sectors. The 1996 crisis hit Bulgaria with unexpected virulence as confidence in the banking system and the currency collapsed. The balance-of-payments recorded a large overall deficit, mainly resulting from capital flight and large external debt service payments. Official reserves declined to less than 1 month of import cover. In 1997, the government had begun implementing a comprehensive stabilization and reform programme, which was yielding positive results sooner than expected. Bulgaria had sustained the liberalization of its trade and exchange rate regime that took place in the early 1990s, and made progress towards eliminating remaining restrictions. It had imposed a temporary 5 per cent import surcharge as part of a stabilisation programme. Foreign exchange reserves were being rebuilt to a level deemed prudent, but Bulgaria would still need to rely on the timely disbursement of official external assistance to meet external debt service obligations. The IMF concluded:

"In sum, while Bulgaria's prospects have improved significantly over the past few months, large external debt service and uncertainties about the timing and impact of the restructuring of the enterprise and banking sectors on the external accounts require vigilant implementation of the adjustment program and prudent management of official foreign exchange reserves. The Fund has emphasized that strong and sustained implementation of appropriate macroeconomic policies will restore balance-of-payments viability and eliminate the need for trade restrictions and has recommended to the authorities that the import surcharge be phased out entirely, well ahead of the existing commitment for end-1999."

58. At the 1998 consultation, the IMF noted that the Government had continued to demonstrate a steadfast commitment to the adjustment programme allowing a restoration of confidence in policies and attracting significant external support. Official reserves had rebounded to a comfortable level of 4.8 months of import cover. The current account was broadly in balance during the first half of 1998, but foreign investment inflows had tapered off significantly reflecting the turmoil in international markets and a slowdown of privatization. With trade liberalization continuing, the economy recovering, and investment projected to increase, the current account was expected to post a small deficit in 1998 which would widen in subsequent years. Foreign direct investment and portfolio inflows were expected to remain modest in light of adverse investor sentiment toward emerging markets. The IMF concluded:

¹¹ WT/BOP/R/34 and R/43.

"The authorities' success in overcoming Bulgaria's balance-of-payments problems, as reflected in the substantial increase in international reserves, has permitted them to reduce the import surcharge as planned and to issue a decree announcing its abolition as of January 1, 1999, eighteen months ahead of initial commitments. The Fund commends the authorities for their sustained commitment to sound economic policies and their preparedness to take bold and difficult decisions to liberalize trade and allow the early elimination of the import surcharge. The authorities remain strongly committed to further trade liberalization, to increasing domestic competition and creating a favorable environment for investment and growth. The three-year program includes significant liberalization of non-tariff barriers, the elimination of remaining export taxes, and the reduction in average tariffs. The authorities are actively considering the acceptance of the obligations under Article VIII, sections, 2, 3, and 4, of the Fund's articles of agreement in the near future. The Fund emphasizes that sustained implementation of appropriate macroeconomic policies and structural reforms will safeguard balance of payments viability and obviate the need for import restrictions."

(xi) *Consulting Member: Romania*¹²

59. Romania consulted in the BOPs Committee in 1998 and 2000.

60. At the 1998 consultation, the IMF noted that Romania's current account deficit had widened. Market concerns about its worsening external position – as reflected in down-grading by major rating agencies and huge spreads on existing sovereign debt – and wariness among multilateral lenders all contributed to lower debt capital inflows. As a result of intervention sales as well as debt service payments, gross foreign reserves declined to 2.2 months of merchandise imports. On unchanged policies, the external outlook for 1999 was worrisome. In late 1998, the Government had announced its intention to intensify policy efforts, with a view to addressing the underlying causes of the widening external imbalance and continued economic decline. The IMF concluded:

"Romania has made significant progress in liberalizing its trade and exchange systems in recent years. ... In recent discussions with the Romanian authorities about the import surcharge, the Fund staff – who had advised against its introduction – urged the authorities to rely on appropriate macroeconomic policies to address the external imbalance rather than trade restrictions, and to eliminate the surcharge by end-1999. In the meantime, the authorities were urged to minimize the distortionary effects of the surcharge, in particular by widening its product coverage."

61. At the consultations in 2000, the IMF noted that Romania had made significant progress in stabilization and reform over the past two years. Large corrections of the fiscal accounts and the exchange rate in 1999 lowered the external current account deficit to a sustainable level, averted a financial crisis, and set the basis for lower inflation and an export-led recovery of output. Gross official foreign reserves reached 2.7 months of import cover, or 130 per cent of short-term debt, at end-July 2000. Provided that policies remained on track, it was expected that the current account deficit would be broadly unchanged from the previous year, and official gross foreign reserves would rise to about 3 months import cover. The IMF concluded:

¹² WT/BOP/R/45 and R/53.

"Romania has made significant progress toward liberalizing its exchange and trade system in recent years. In 1997, all remaining quantitative restrictions on exports were eliminated and replaced with automatic licensing for statistical purposes, and all quantitative restrictions on imports were removed. On 10 October 1998, the Romanian authorities imposed a 6 per cent import surcharge, which was lowered to 4 per cent at the beginning of 1999 and to 2 per cent at the beginning of 2000. In the context of undertakings under the Fund-supported programme, the authorities have confirmed their intention to eliminate the import surcharge at the beginning of 2001, in line with an originally established schedule."

III. RESERVE ADEQUACY IN THE CONTEXT OF WTO DISPUTE SETTLEMENT PROCEEDINGS

62. In the course of dispute settlement proceedings on *India – Quantitative Restrictions on Imports of Agricultural, Textile and Industrial Products*¹³, the Panel submitted a series of written questions to the IMF which the Panel considered relevant to its examination of India's balance-of-payments situation. The questions, and the answers from the IMF, were as follows:

1(a)(i) *As of 18 November 1997, the date of establishment of the Panel, was India experiencing a serious decline in its monetary reserves, or facing a threat thereof?*

Foreign currency reserves of India's monetary authorities (the Reserve Bank of India, RBI) stood at US\$25.1 billion (excluding gold) on 21 November 1997.¹⁴ This level represented an increase of US\$5.6 billion from a year earlier, and of US\$2.8 billion from end-March 1997.¹⁵ Net of forward liabilities, foreign currency reserves stood at US\$23 billion at end-November 1997.

The establishment of the WTO panel coincided with a period of turbulence in the foreign exchange market in India, with increased fears of further contagion from the financial crisis in east and southeast Asia. The facts are as follows: the rupee faced periodic bouts of downward pressure beginning in August 1997. These pressures intensified in November 1997. The RBI initially intervened heavily in spot and forward markets to prevent large daily fluctuations in the exchange rate that could have provoked bandwagon effects. Faced with a reserve loss of about US\$2.6 billion (including forward obligations) during November 1997, and continued pressure on the rupee, the RBI subsequently abandoned active intervention and tightened monetary policy. Thus, with an appropriate macroeconomic policy response and the containment of contagion, India's foreign currency reserves on 18 November 1997 did not appear to be under a threat of a serious decline. Therefore, the question of whether an imminent threat existed is moot.

1(a)(ii) *Was India experiencing an inadequate, or a very low, level of monetary reserves ?*

At about 6 months of imports of goods and non-factor services, India's reserves appeared to provide sufficient external liquidity and a reasonable degree of protection against unforeseen external shocks. In particular, reserves were sufficient to deal with debt service payments and potential outflows of portfolio investment, covering 2½ times the amount of maturing debt obligations in the next twelve months and 1½ times the stock of short-term debt and cumulative inflows of portfolio investment. Therefore, it is the Fund's view that the level of foreign currency reserves on November 18, 1997 was adequate.

¹³ WT/DS90/R, 6 April 1999.

¹⁴ Data on official reserves are published weekly by the RBI. On 13 November 1997, foreign currency reserves were at US\$26 billion. Data on the RBI's outstanding net forward sales or purchases are published monthly.

¹⁵ India's financial years runs from 1 April to 31 March.

1(a)(iii) *Was India experiencing a reasonable rate of increase in its monetary reserves?*

Gross foreign currency reserves fell by US\$1.9 billion in November 1997. (Net of the RBI's forward obligations, foreign currency reserves fell by US\$2.6 billion that month.) From a broader perspective, however, there has been a reasonable rate of accumulation of reserves since India's balance-of-payments crisis in 1991. For example, at end-November 1997, reserves were up US\$5 billion from a year earlier. (Net of forward obligations, this increase was US\$4.5 billion.)

1(b) *In connection with responding to these questions, could the IMF indicate what would have constituted a serious decline in India's monetary reserves, what would have constituted an inadequate, or a very low, level of monetary reserves for India, and what would have constituted a reasonable rate of increase in India's monetary reserves?*

A considerable degree of subjective judgment is involved in an assessment of the adequacy of the level and rate of change of reserves. The Fund's view on this question is based on the size of existing and potential claims on reserves, examined in the context of the country's economic circumstances. In the case of India, policy has prudently aimed at ensuring that reserve coverage is ahead of the sum of outstanding short-term liabilities (by remaining maturity) and potential outflows of portfolio investment. As of November 1997, short-term liabilities (by remaining maturity) and the stock of portfolio investment (after marking-to-market) were estimated at about US\$16 billion. Hence, a decline in reserves to significantly below this level would be considered serious, and such levels could be deemed inadequate or very low. In case reserves were deemed to be inadequate at this threshold, any increase in reserves that would bring them above this level should be considered reasonable.

2(a) *Could the IMF provide the Panel with any statistical and other factual information relating to India's balance of payments and monetary reserves which might be relevant in order to enable the Panel to determine whether, as of 18 November 1997, the quantitative restrictions notified by India as being maintained for balance-of-payments reasons did, or did not, exceed those necessary to forestall the threat of, or to stop, a serious decline in its monetary reserves, or, in case its monetary reserves were inadequate, to achieve a reasonable rate of increase in its reserves?*

India's overall balance of payments recorded sizable surpluses in 1996/97 and 1997/98, while the current account deficit remained in the range of 1-1½ of GDP (see attached table). However, export performance in dollar terms has weakened. Exports grew by 2½% in dollar terms in 1997/98, compared with 4½% in the previous year, markedly below the growth rates recorded in recent years. In contrast, measured in volume terms the performance of exports has been better. Although the performance of exports is partly explained by weaker demand in world markets and sector-specific factors that are expected to be temporary, it has also reflected structural problems such as infrastructure constraints and the lack of reforms in the small-scale sector.¹⁶ Imports rose by 5% in dollar terms in 1997/98 (compared with 10% in 1996/97). Declining oil imports (both in volume and dollar terms) were offset by an increase in non-oil imports (up 12½% for the year), partly in response to the relaxation of some controls on consumer goods imports.

Despite the slowdown in exports, the external position has remained manageable. Strong inflows of private capital (both portfolio investment and foreign direct investment) boosted foreign currency reserves in 1996/97 by US\$5.3 billion to US\$22.4 billion (5½ months of imports of goods and non-factor services) at end-March 1997. In 1997/98, robust inflows of portfolio investment in the

¹⁶ Small-scale units are defined as manufacturing units in which investment in plant and machinery is less than Rs 30 million (about US\$700,000). These units enjoy special protection from both domestic and international competition. About 800 products are reserved for production by small-scale units. The small-scale sector's products account for roughly half of all exports.

first half of the year turned to modest net outflows in the second half, responding to changes in investor sentiment toward emerging markets following the Asian crisis. Moreover, higher premia for debt issued overseas by Indian corporations discouraged foreign borrowing. However, rising foreign direct investment, driven by longer term considerations, helped maintain a comfortable reserve position.

- 2(b) *Were there any special factors, within the meaning of GATT Article XVIII:9, affecting India's reserves and its need thereof, that the IMF considers relevant?*

With respect to special factors, within the meaning of GATT Article XVIII:9, the Fund understands the following factors to be relevant. With the exception of net forward liabilities totalling US\$1.4 billion at end-November 1997, there were neither contingent liabilities nor any unusually high obligations affecting India's reserves. With regard to prospective developments in debt-service payments, amortization and interest payments in 1997/98 and 1998/99 were expected to return to lower levels after peaking in 1995/96 and 1996/97.

3. *Noting that these restrictions relate mainly to consumption goods, would relaxation or removal of the restrictions, as of 18 November 1997, have been likely to produce thereupon "conditions justifying the intensification or institution, respectively, of restrictions under paragraph 9 of Article XVIII" (Ad Note to Article XVIII:11)?*

The Fund's view remains as indicated in the statement to the WTO Committee on Balance-of-Payments Restrictions (10-11 June 1997), namely that the external situation can be managed using macroeconomic policy instruments alone. Quantitative restrictions (QRs) are not needed for balance-of-payments adjustment and should be removed over a relatively short period of time. The tariffs applied to previously restricted consumer goods imports could initially be kept close to the top of the existing tariff structure, but should be scaled back according to a pre-announced timetable. A time-bound programme for eliminating the remaining QRs over a relatively short period would reduce distortions to investment and promote an efficient, export-oriented consumer goods sector. The macroeconomic policy instruments would need to be complemented by structural measures such as scaling back reservations on certain products for small-scale units and pushing ahead with agricultural reforms.

4. *Have there been any external or internal developments affecting the Indian economy since the date of establishment of the Panel that could lead to a modification of the IMF's answers to questions 1 to 3?*

There has been a deterioration in the economic outlook and market sentiment over the past few months, and short-term risks have increased. This deterioration stems from both domestic and external factors. The growth momentum has continued to weaken, the Central Government's fiscal position worsened in 1997/98, and investor confidence has abruptly eroded. At the same time the external environment has become more uncertain. A deeper and more prolonged recession in East Asia could reduce external demand and make an export recovery more difficult. The imposition of sanctions following the nuclear tests in May 1998 and continued financial turbulence in the region have also resulted in greater external vulnerability, including from changes in market sentiment, although foreign currency reserves remained at a relatively comfortable US\$24.1 billion (over 5½ months of imports) at end-June 1998. These uncertainties undoubtedly add to near-term risks and will require especially close monitoring while the impact of the sanctions and regional developments work their way through the economy. In sum, on the basis of developments thus far, the balance of payments situation is expected to worsen and a decline in reserves (US\$2½-4 billion) is anticipated for 1998/99. Nevertheless, it remains the Fund view that the external situation can be managed using macroeconomic policy instruments and that quantitative restrictions are not needed for balance-of-payments adjustment.

- 5(a) *If India immediately removed the remaining quantitative restrictions referred to above, would India need to change its development policy in order not to experience a serious decline in its monetary reserves or the threat of a serious decline in its monetary reserves, or (if India were to have inadequate monetary reserves) in order to achieve a reasonable rate of increase in its reserves?*

Some problems in import substituting sectors and a temporary decline in reserves cannot be ruled out in the event India immediately removed the remaining QRs. As noted in response to question 2(a), the recent increase in non-oil imports is partly in response to the relaxation of some of the controls on consumer goods imports over the last year. However, there would also be considerable benefits to such a move, if it were implemented in a phased manner over a relatively short period. First, increased customs revenue from the tariffs applied to previously restricted consumer goods imports would contribute toward deficit reduction and could provide the necessary resources for essential spending in infrastructure and the social sectors. Second, a more competitive, efficient, and quality-conscious consumer goods sector could contribute strongly to export growth. Finally, the structural measures advocated in response to question 3 would improve the allocation of investment, promote efficiency, and enhance the growth prospects of the economy.

- 5(b) *Would serious structural adjustment problems, other than balance of payments problems, be likely to result from the removal of these restrictions?*

It is the Fund's judgment that removal of the QRs on consumer goods imports would enhance competitive forces and efficiency in the economy, thus promoting trade and growth. Nevertheless, there would be some inevitable adjustment in protected industries, the consequences of which could be exacerbated by existing rigid labour laws for the organized sector. The removal of import restrictions, however, would also provide fresh impetus for reforms in other areas as the existence of certain controls on the domestic economy (such as for small-scale units) would become less meaningful.

IV. RECENT WORK BY THE IMF ON RESERVE ADEQUACY ISSUES

63. In 1999, the Secretariat, after consultation with IMF staff, prepared a Note for the General Council on "The Treatment of 'Monetary Reserves' in WTO Balance-of-Payments Consultations".¹⁷ There, it was noted that the IMF was examining closely the treatment of reserves in the context of its work on strengthening the international financial architecture. This work involved examining the various measures to gauge adequacy of reserve coverage, especially capital account-based measures, and the consistency of measurement across countries. The IMF staff increasingly monitored the level of reserves over short-term debt by remaining maturity for emerging market economies.

64. The Note went on to say that "rules of thumb" that had been used in the past to measure the adequacy of a Member's level of monetary reserves, such as a certain number of months of import cover, were designed primarily with current account considerations in mind, often in the context of a Member maintaining a fixed exchange rate peg. With more and more WTO Members opting to allow their exchange rates to float, their need to maintain a particular level of monetary reserves in order to help defend, when necessary, their exchange rates may be reduced. However, it was not possible to be categorical on this point; Members with floating exchange rates and weak banking systems may nevertheless need to maintain significant reserves.

65. With more and more WTO Members participating actively on international capital markets, capital account developments have taken on increased importance for many Members in prudent management of their overall balance-of-payments situation, as the recent "emerging markets" financial crisis has shown. One implication of this was that trade restrictions were a less suitable tool

¹⁷ WT/TF/COH/S/2, 18 June 1999.

for managing balance-of-payments problems, where these relate to capital account as opposed to current account developments. At the same time, what constituted an adequate level of monetary reserves for these Members to be able to withstand both cyclical and unanticipated shocks deriving from capital account developments needed to be assessed on a case-by-case basis. Internal guidance in the IMF for assessing reserve adequacy had increasingly emphasised that a close focus on short-term debt by remaining maturity is generally warranted. Moreover, in assessing available reserve levels, the derivative and contingent asset and liability position of the authorities needed to be considered.¹⁸

66. Since that Note was distributed, the IMF has developed "Guidelines for Foreign Exchange Reserve Management" as part of a broader work programme to help strengthen the international financial architecture, to promote policies and practices that contribute to stability and transparency in the financial sector, and to reduce external vulnerabilities of its member countries. The Guidelines were issued in March 2001. They state, *inter alia*, that:

"There are no universally applicable measures for assessing the adequacy of reserves and the determination of reserve adequacy falls beyond the scope of these guidelines. Relevant factors have traditionally included a country's monetary and exchange arrangements, and the size, nature and variability of its balance-of-payments and external position. More recently, financial risks associated with a country's external debt position and the volatility of its capital flows have received particular attention, especially for economies with sufficient but not fully certain access to international markets."¹⁹

67. Prior to issuing the Guidelines, the IMF took stock of changes that had taken place in the framework for evaluating reserve adequacy, and commented as follows.

"For much of the second half of the twentieth century, the rule of thumb was that reserves should provide at least 3 months of import coverage as a minimum desirable target for reserves. Reserve floors in many IMF-supported economic programmes have been based on achieving such a minimum level. Market participants had also widely used this rule to gauge reserve adequacy. Indeed, the median observed reserve levels during the past fifty years mostly fell in the range of 3 to 4 months of imports. Following the spate of financial crises in the 1990s, reserves in these [crisis-affected] countries increased substantially, reflecting, among other things, a new appreciation of the importance of adequate reserves.

"With the rise in private capital flows, the focus of reserve adequacy on trade – and the rule about 3 months import coverage in particular – had increasingly come to be regarded as out of date for many countries. At the same time, the crises that affected emerging market countries in the 1990s had driven home the point that capital flows were important in financing the balance-of-payments and that access to these private capital flows was often uncertain and subject to rapid reversal. Such reversals could contribute to a liquidity squeeze and can result in or aggravate external crises.

¹⁸ *Ibid*, paras 53-54.

¹⁹ "Guidelines for Foreign Exchange Reserve Management" IMF, 20 September 2001, available on the IMF website at www.imf.org.

"Thus, a search had begun for new policy rules to assess reserve adequacy that reflected capital account and crisis prevention considerations. With crisis prevention as the primary objective, policymakers ... took the lead in proposing a new rule of thumb that targeted coverage of short-term debt by remaining maturity as the main criterion for setting reserve levels. ... [This rule] provided a natural departing point for considering more complex situations arising in individual country cases. [It] should be viewed as a starting point for analysing reserve adequacy for a country with significant but uncertain access to capital markets. Several other considerations for assessing reserve adequacy also had been found to be key [*inter alia*] ... general empirical analysis strongly suggested that other fundamentals, notably the current account deficit and real effective exchange rate misalignments, affected the need for reserves. For countries with limited access to capital markets, the traditional arguments applied: without access to private capital, reserves were needed to absorb and smooth shocks, such as declining export volumes or increasing import prices.

"Did this mean that the traditional rule of thumb of 3 months of imports of goods and services is no longer useful? It was likely that reserves would continue to be expressed in terms of imports, especially for countries with limited access to capital markets, because this continued to be universally available and easily interpretable. However, the motivation for the level of reserves held should be justified in broader terms ... Such an approach, in practice, could be expected to lead to a much wider range of observed levels of reserves, when expressed in terms of imports, and a much greater focus on reporting and comparing reserves in terms of other measures, such as short-term debt."²⁰

68. A more detailed IMF staff analysis of the potential implications of focusing an assessment of the adequacy of monetary reserves on the capital account was published in October 2001.²¹ The analysis stated that "from a crisis prevention point perspective, the most relevant indicator of reserve adequacy for emerging market countries is the ratio of international reserves to short-term external debt by remaining maturity. Higher levels of reserves would be preferable in countries with problematic characteristics – e.g., weak macroeconomic fundamentals (such as large current account deficits that raise financing needs and overvalued exchange rates that can lead to capital outflows), high levels of short-term public domestic debt (especially where there are no effective capital controls or other mechanisms that create captive markets), derivative positions of the public sector, and weak banking systems that can contribute to capital flight – although it will likely be difficult for such countries to build reserves. Considerations that *limit* the need for reserves include: the presence of a flexible exchange rate regime to stem capital flight; management of the actual exchange rate policy in a manner that discourages high foreign exchange exposure by the private sector; a public sector that borrows in domestic currency from non-residents, and can do so in case of liquidity need; conditions that ensure private sector access to foreign capital such as sound private sector risk management and banking supervision. To take such additional factors into account and allow a better understanding of the interaction between reserve adequacy, vulnerability, and country-specific factors and policies, the

²⁰ "Reserves should be adequate to reflect increase in capital account flows, needed for crisis prevention", IMF Survey, 19 February 2001.

²¹ "Issues in Reserves Adequacy and Management", IMF Executive Board Document, prepared by the Monetary and Exchange Affairs Department and Policy Development and Review Department, 15 October 2001, available on the IMF website at www.imf.org.

benchmarking of reserves to short-term debt should be complemented by stress testing of the balance-of-payments".
