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Intereconomics

*Suggested Citation:* Lang, Franz Peter (1988) : Sanctions under GATT article XIX versus voluntary export restraints, Intereconomics, ISSN 0020-5346, Verlag Weltarchiv, Hamburg, Vol. 23, Iss. 4, pp. 178-183,  
<https://doi.org/10.1007/BF02925107>

This Version is available at:

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Franz Peter Lang\*

## Sanctions under GATT Article XIX versus Voluntary Export Restraints

*Voluntary export restraints play a substantial part in international trade today. This article compares the effects such restraints have upon certain exporting countries with the effect of sanctions applied under Article XIX of the GATT. It is shown that the microeconomic protectionism analysis used as a basis for the current debate on the reform of the GATT is unable to provide a conclusive answer as to which variant of protectionism would be preferable from the exporting economies' point of view. The article also indicates the direction in which existing research shortcomings can be reduced.*

One of the key points characterized by the popular term "neo-protectionism" is the remarkable numerical increase in protectionist measures during the more recent history of world trade. These include all types of measure, whether tariff or non-tariff: compensatory tariffs, variable import levies, direct or indirect export subsidies, import and export quotas, administrative obstacles via regulations on dimensions and specifications, delays in arranging finance or granting customs clearance, etc. This trend towards impeding free trade is described as "the quantitative aspect of neo-protectionism". It constitutes the most conspicuous motive for efforts to reform the General Agreement on Tariffs and Trade (GATT).

Among the most important economic causes of the escalation in protectionism named in the reform debate are the increasing "competitive pressure" on world markets from newly industrialising countries, the diminished flexibility of highly developed industrial countries in adapting to changes in the structures of world trade (inability to adjust to the product cycle), and the now urgent need to reduce the USA's excessive imports as a consequence of its high budget deficit (adjustment of the balance of payments, and the international debt problem).<sup>1</sup> It should be noted that the above trend is occurring partly within the framework of the GATT via the increased use of tariffs, but also increasingly outside the ambit of the GATT or indeed by

undermining GATT regulations using measures not dealt with by the treaty.

The much-discussed Article XIX of the GATT provides for what are termed "compensatory tariffs" to be placed on imports as a protective measure if a GATT member country experiences severe disadvantages for its import-competing industries as a result of the free-trading relations presided over by the GATT. However, a precondition for taking such protective measures is that agreements are reached and compensation agreed to the benefit of the exporting countries affected by the measures, and that this is done in accordance with strict rules (on publicity, declaration periods, etc.).<sup>2</sup> In the event, the negotiations involved often prove difficult and success in reaching an agreement is by no means guaranteed.

If negotiations fail and the sanctions under Article XIX are eventually imposed, there is then a danger that the exporting countries discriminated against will resort to retaliatory action. Despite this, increasing use is nevertheless being made of discriminatory defensive tariffs under GATT rules, especially by member countries such as the USA whose export dependence is low.

<sup>1</sup>Cf. among others C. F. J. Boonekamp: Voluntary Export Restraints, in: Finance & Development, December 1987, pp. 2 ff.; C. Hamilton: Economic Aspects of Voluntary Export Restraints, p. 112, in: D. Greenway (ed.): Current Issues in International Trade, Theory and Policy, London 1985, pp. 99 ff.; F. P. Lang: Neo-Protectionism and Economic Growth, in: INTERECONOMICS, No. 3, 1984, pp. 129 ff.

<sup>2</sup> Cf. H.-D. Smets: Importschutz und GATT, Berne 1987.

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Because negotiations in the cases covered by Article XIX are so long drawn out and may end in failure, and because even if they are successful it will become clear in the process to those parts of the importing country's domestic economy not directly benefiting from protectionist measures that these also generate unfavourable effects, there is quite an incentive for importing countries which have had enough of free trade to agree to "voluntary export restraints" by the exporting countries.

To cite an example, the number of voluntary export restraints undergone in the USA's favour during the period 1970-1985 was three times as high as the number of defensive tariffs declared by the USA under Article XIX. In the case of the EC and its member countries, the number of cases of self-restraint in their favour actually exceeds the number of measures taken under Article XIX by a factor of nine. In 1984, approximately 40 % of the EC's imports from Japan and 33 % of American imports from that country were subject to voluntary self-restraint.<sup>3</sup>

The growing use of such voluntary export restraints is the "qualitative aspect of neo-protectionism".<sup>4</sup> This will be the area of concern for the considerations which follow.

## Voluntary Export Restraints

A "voluntary export restraint" is a measure by which a government or branch of industry in an importing country comes to an agreement with the government or the competing industry in an exporting country upon quantitative export restrictions for one or more products.<sup>5</sup> However, such restraints are also frequently declared unilaterally by an exporting country without establishing any bilateral agreement or, in other words, without the considerable negotiating efforts otherwise required. This may enable it to preempt potential defensive tariffs by depriving them of the justification they need under the terms of the GATT.

This flexible and discrete approach clearly represents a substantial advantage on the part of this "classical" instrument of neo-protectionism when set against sanctions under the terms of Article XIX. Moreover, in

such a "voluntary" form a quantitative export restraint is not controlled by the GATT's statutes, which only prohibit discriminatory, sovereign measures involving tariffs, duties or taxes.<sup>6</sup> Another factor is that voluntary export restraints are beneficial to the popularity of the exporting country and its products in the importing country. This increases its readiness to undertake voluntary export restraints. Quite apart from the aspects already mentioned, however, the exporting industries concerned also see major economic advantages in voluntary export restraints.

## Traditional Comparison

If a compensatory tariff under the terms of Article XIX is imposed, the price on the protected market rises as a result. This generates the familiar protective effects for import-competing industries. These effects will not be considered here.<sup>7</sup>

The price in the protected market will rise particularly strongly if the price elasticity on either side of the market is low (low responsiveness). Conversely, if either side of the market reacts strongly in quantity terms to changes in price (high responsiveness), the rise in price will be relatively slight. Either of these constellations is possible in situations where Article XIX is resorted to.

In the former case, for example, the intention might be to use protection as an aid to expanding the capacity of domestic suppliers over the long term – too low a level of capacity is one possible cause of the low supply elasticity of import substitutes. This motive for protectionism is especially prevalent in the developing countries (infant-industry protectionism).

In the second case where price elasticity is high, there is generally a sufficient reserve of capacity but this is unused because of better-priced import competition. Using protective measures to eliminate this competition from imports then allows capacity to be used at the desired higher level. If domestic suppliers are displaced by price competition this usually results from an unfavourable cost structure when compared internationally. The resulting limited international competitiveness is a motive for protectionism primarily in the industrial countries.

<sup>3</sup> Ibid., pp. 6 ff.

<sup>4</sup> In addition, there is a growing number of countries (especially in the Eastern bloc) which are carrying out trade but are not GATT members and hence not obliged to abide by its rules. To the extent that they take protectionist measures the direct effects on their own economy are much more important to them than having regard, whether contractually or morally, to free trade agreements.

<sup>5</sup> B. Hindley: Voluntary Export Restraints and Article XIX of the GATT, in: J. Black et al. (eds.): Current Issues in Commercial Policy and Diplomacy, London 1978, pp. 52 ff.

<sup>6</sup> Cf. C. F. J. Boonekamp, op. cit., p. 3; C. Hamilton, op. cit., p. 112.

<sup>7</sup> The use to which the tariff income is put could give rise to effects which would differentiate the compulsory tariff option from voluntary export restraints. These are largely ignored in political discussions, however. On this, cf. M. Frenkel: Makroökonomik des Protektionismus bei festen und flexiblen Wechselkursen, Hamburg 1985; by the same author: Gesamtwirtschaftliche Effekte globaler protektionistischer Maßnahmen, in: Jahrbuch für Sozialwissenschaft, 37, 1986, pp. 200 ff.

Regardless of the importing country's motive, the quantity of goods sold by the exporting country in the tariff-protected market will decline. The exporters do not receive any share of the increased unit prices because the tariff is levied by official bodies in the importing country. The defensive tariff therefore results in a reduction of both the quantity exported and export revenues.

If, on the other hand, the exporting country exercises voluntary restraint with regard to the quantity it supplies, hence avoiding any measures the importing country might otherwise take under Article XIX, the price effect in the protected market will be the same. The immediate protective effects enjoyed by domestic suppliers in the importing country are thus the same under this form of export quota as they would be under a compensatory tariff.

However, there is an important difference as far as the exporting country is concerned. If price elasticity on the two sides of the import market is relatively low, it is possible for the relatively pronounced rise in the export price to more than compensate for the quantity reduction resulting from the export restraint. Export earnings from the protected market can then rise above their level before any measures were taken.

By contrast, if the responsiveness of the protected sales market to price changes is relatively high, the increase in the export price will turn out relatively low. In this situation the fall in sales as a result of the voluntary restraint will more than cancel out the effect of the slight rise in unit revenue, so that overall export revenue can fall below its initial level. Nevertheless, it will still be higher than it would have been if a compensatory tariff had been accepted.

The positive differential between export revenue when voluntary restraint is exercised and export revenue when an import tariff is accepted is termed the "net gain from voluntary export restraint". This serves as an indicator of the advantageousness of engaging in voluntary export restraint rather than having to accept Article XIX tariffs. From the exporting country's point of view, then, the former is quite clearly the better strategy.<sup>8</sup>

Empirical analyses seek to estimate this net gain from voluntary export restraint. Their intention is to thus explain the growing tendency to engage in voluntary restraints, hence justifying them as economically rational behaviour in a protectionist world. Table 1

illustrates these "net gains" for Hong Kong, with attention focused on exports of clothing, an important market for the city state. Evidently, these "net gains" are not inconsiderable, whether for the textile industry or for Hong Kong's export-oriented economy as a whole. Because textiles represent one of Hong Kong's most significant export markets, the "net gains" have substantial effects on the overall economy. The question as to which variant of protectionism is more favourable to the exporting country from a single industry and from an overall economic point of view would therefore appear to be unequivocally answered, with voluntary export restraints coming out on top.

However, the measurement concept used to calculate the net gains<sup>9</sup> is based on the conventional method of microeconomic protectionism analysis, namely the model of the single export market. This assumes that the protectionist measure applies equally to the whole world – an unrealistic assumption.

### Export Market Segmentation and Market Power

In reality various segments of an export market can usually be distinguished from one another. This is shown by the examination of Hong Kong, South Korea and Taiwan in Table 2. It defines the EC and US textile markets as separate segments of the "big three's" export markets. Among the factors enabling these segments to be delineated are geographical distance, differing customer preferences and different competitive conditions.

It is only in segmented markets that the discriminatory protectionism with which we are familiar today can be practised. Under such conditions an exporting country which has had a defensive tariff imposed against it under Article XIX or has pledged voluntary export restraint to specific countries (export market segments) has the opportunity to divert surplus production which can no longer be sold in the protected market segment to other segments on the "free world market" which are relatively free from protectionist measures.

If it is possible to dispose of this surplus production in conditions of complete demand elasticity, the additional supply will leave the free market export price more or less unchanged. The loss of export revenue due to the defensive tariff in the protected market segment is

<sup>8</sup> This traditional assessment was recently reaffirmed by H. Herberg in an unpublished paper delivered at the annual conference of the committee on trade and the international economy within the "Verein für Socialpolitik", held in Fulda on 13th May, 1988.

<sup>9</sup> Cf. among others, A. Azraff: *World Trade and Protectionism*, mimeo, Department of Economics, Boston College, 1987, pp. 51 ff.; C. Hamilton: *Restrictiveness and International Transmission of the "New" Protectionism*, Seminar Paper No. 367, Institute for International Economic Studies, University of Stockholm, October 1986, p. 6; B. Hindley, op. cit.; F. D. Weiss: *Importrestriktionen der Bundesrepublik Deutschland*, in: *Die Weltwirtschaft*, No. 1, 1985, pp. 88 ff.

roughly compensated for by the gain in export revenue in the free market segment. If the exporting country were to give preference to voluntary export restraint, however, this could clearly improve its position due to the additional "net gain from voluntary export restraint".

It should be noted, though, that the above scenario describes the conditions faced by an exporting country unable to influence prices in its free export markets. Yet countries such as Hong Kong, South Korea and Taiwan which are threatened with sanctions under Article XIX in reality actually wield power in their major export markets. The policies they pursue with regard to quantity supplied have an influence on their export prices. An indication of this is provided by the high market shares of the "big three" in the different segments of the textile export market (Table 2). In this market, they act as "major players", whereas they are only able to act as "minor players" in their import markets (for raw materials, food, machinery etc.), where they are price-takers.

**Table 1**  
**Net Gain from Voluntary Export Restraint Relating to Hong Kong's Clothing Exports**  
(in HK\$ billion)

Importing country	Amount
Benelux	10
Denmark	7
France	6
Germany (Fed. Republic)	94
Sweden	47
United Kingdom	100
USA	302
Total	566

Source: C. Hamilton: Economic Aspects of Voluntary Export Restraints, p. 112, in: D. Greenway (ed.): Current Issues in International Trade, Theory and Policy, London 1985. (The net gain amounts to approx. 1% of the city state's GDP, or 16% of the value of the clothing industry's production).

**Table 2**  
**The "Big Three's"<sup>1</sup> Share of the US and EC Textile Markets**

Share of the "big three" in the US textile market	60%
Hong Kong's share	24%
Share of the "big three" in the EC textile market (EC internal trade excluded)	32%
Hong Kong's share	18%

Source: C. Hamilton: Restrictiveness and International Transmission of the "New" Protectionism, Seminar Paper No. 367, Institute for International Economic Studies, University of Stockholm, October 1986, p. 6.

<sup>1</sup> The countries known as the "big three" on the world textile market are Hong Kong, Taiwan and South Korea.

If the exporting country does have some power over the market, the price obtained for the diverted production in the free segment of the market will fall as a result of that diversion. The drop in the free export price will be all the greater, the lower the elasticities of supply and demand in the free segment of the export market. Thus an indirect consequence of protectionist measures is a fall in export revenues from the free market segment in comparison with the initial situation. It is therefore important that the analysis should also include the indirect effects of protectionism upon the free export market segment.

### Power in the Free Export Market

According to the considerations so far made, whenever a compensatory tariff is accepted, export revenues from the protected market always fall. Given that the diversion of surplus export production to the free market segment also means it can be less profitably sold there, the fall in the overall value of exports as a consequence of the compensatory tariff is quite unequivocal. Hence the qualitative findings of the simple underlying microeconomic model are also confirmed by the extended analytical framework.

The difference with voluntary export restraint is that it may lead to an increased export revenue from the protected market segment if price elasticities there are low. Revenue will fall, on the other hand, if the response to price changes in the protected segment is high. As a rule, though, any such fall turns out smaller than it would have been had a compensatory tariff been imposed. The effects flowing from the diversion of surplus export production to the free export market segment do, of course, remain the same as in the compensatory tariff case.

In the event of differing elasticities between various export market segments, then, the total revenue from all segments may rise, fall or remain constant. The constant total revenue case will be ignored in the treatment which follows.

An increase in total export revenue occurs if elasticities in the protected export market segment are low while there is a high price elasticity in the free market segment. These are the conditions under which the findings of the basic, single-market model of protectionism analysis are confirmed. A fall in the total export revenue obtained occurs if the protected market segment is marked by high elasticities and the free market segment by low ones. Under such conditions the "net gain from voluntary export restraint" may be more

than cancelled out by revenue losses in the free market segment. These findings therefore differ from those of the single-market model.

Even after market segmentation and market power in the protected segment have been considered, however, the decision will still be that voluntary export restraints are more advantageous than accepting compensatory tariffs under the terms of the GATT! The effects of a compensatory tariff and of voluntary restraint differ as far as the protected market is concerned but are the same with regard to the free market segment. Because the fall-off in export revenue from the protected market is invariably smaller for voluntary restraints than for the acceptance of a compensatory tariff under GATT terms, voluntary export restraint once again proves to be the superior policy instrument. This does of course always assume that a compensatory tariff under Article XIX can

be expected to be imposed. Should this not be the case, there would naturally be disadvantages from the avoidable decline in total export revenue caused by the voluntary restraint.

### Exchange-rate Effects

To a substantial degree, the group of countries under consideration conduct their foreign trade under a system of floating exchange rates (e.g. against the dollar zone and the EMS).<sup>10</sup> As a major contributor to the supply of foreign exchange, total export revenues are a crucial determinant of the exporting country's exchange rate. If export revenue increases, so too does the supply of foreign exchange, and foreign currencies are devalued. Conversely, a fall in export revenue means foreign currencies will be shorter in supply and their value will increase.

Since neo-protectionism alters export revenues in both of the variants discussed here, it will inevitably also have an effect on exchange rates. Equally, because these in turn affect export and import prices as expressed in domestic currency, an assessment of neo-

<sup>10</sup> A more differentiated analysis has to be made if two exchange rates are involved – e.g. Hong Kong \$-EMS/Deutschmark and HK\$-US\$ – one of which is strongly tied to the US\$ (perhaps via a basket of currencies) while one of the two foreign currencies represents the protected export market segment and the other the free export market segment.

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protectionist measures should not ignore exchange-rate effects. First conclusions which can lead on to a macroeconomic analysis of these questions can already be drawn from the alternative situations which have so far been considered.

The acceptance of a compensatory tariff leads to a fall in export revenue, and therefore in the supply of foreign exchange, regardless of conditions in the protected and free market segments. One must therefore expect the compensatory tariff to have the consequence of increasing the value of foreign currencies. There is an assumption involved here which is not always realistic for the group of countries under consideration but does for example apply to Japan, namely that the exporting country invoices its exports and imports in one and the same currency, e.g. US dollars. If instead of this trade is invoiced, for example, in different currencies for different export segments, with the possibility in reality of the exporting country's currency being tied to the currency of that market segment under certain circumstances,<sup>11</sup> the theoretical analysis will have to be conducted in such individual cases using a three-country model. The latter constellation will not be considered here.

One effect of the foreign currency revaluation is that the unit price received by exporters rises when expressed in domestic currency. However, another is that import prices also rise in domestic currency. Hence a compensatory tariff imposed by the importing country produces a favourable currency effect for both exporters and import substitution industries in the exporting country, whereas users of imported goods there will be disadvantaged. The extent to which the exporting country's economy is adversely affected by a compensatory tariff therefore varies according to its level of import dependence, the proportion of imported inputs used in export production, and the degree of export orientation.

The supply of foreign exchange may react in a number of ways to voluntary export restraint (as was the case for the development of exports as a whole).

A devaluation of the foreign currency occurs if price elasticities are low in the protected export segment but very high in the free market segment. This devaluation leads to a reduction in export prices expressed in domestic currency, and lowers import prices for inputs and finished goods. It is then questionable whether the exporting country will be able to transfer the benefit of its

"net gain from voluntary export restraint". On the other hand, if exporting industries use a high proportion of imported inputs their position will be eased. Other parts of the exporting country's economy will be subjected to intensified competitive pressure from imports.

A revaluation of the foreign currency occurs if the protected market segment is characterized by high price elasticities whereas low elasticities prevail in the free market segment. In qualitative terms, this is the same effect as that of a compensatory tariff, with corresponding consequences for the exporting country's economy. As was shown in the treatment of export revenues above, however, the changes in the supply of foreign exchange certainly occur in the same direction for voluntary export restraint as they would for an accepted compensatory tariff, yet are different in quantitative terms.

In the event of voluntary export restraint being exercised, any revaluation of the foreign currency would tend to be less than it would have been had a compensatory tariff been imposed, due to the counter-effect of the "net gain from voluntary export restraint". The exchange-rate effects of protectionism sketched out here demonstrate the need for the analysis to take more account of overall economic interdependences than is the case with conventional protectionism theory.

## Extending Protectionism Analysis

In spite of the further elaborations undertaken in this article, the single-market model of microeconomic theory which underlies the debate on protectionism proves inadequate as a basis for deciding upon an optimal strategy under protectionist world trading conditions.

Although extending the range of premises does provide a better differentiated picture of the possible effects of either accepting a defensive tariff or engaging in voluntary export restraint, it also discloses a great many interdependences not previously considered in this context, and these are what now need to be dealt with by policy-oriented protectionism analysis.

One possible way of realizing this is to make the transition to aggregated macroanalysis.<sup>12</sup> An improved information base on the problem area of neo-protectionism is indispensable, particularly because the current debate on the reform of the GATT has so far been conducted without any adequate macrotheoretical basis.

<sup>11</sup> Cf. D. Bender: Monetary Stability, Export Promotion and Exchange Rate Policy. A Macro Model of Exchange Rate Movement in NICs and its Application to Singapore 1975-83, in: ASEAN Economic Bulletin, Vol. 2, 1986, pp. 196 ff.

<sup>12</sup> Cf. F. P. Lang: Macroanalysis of Voluntary Export Restraints, (mimeo), forthcoming.