

WORLD TRADE ORGANIZATION

RESTRICTED

WT/BOP/8

BOP/326

31 October 1995

(95/3363)

Committee on Balance-of-Payments Restrictions

CONSULTATION WITH SRI LANKA UNDER ARTICLE XVIII:12 (b) OF THE GATT 1994 AND THE RELATED UNDERSTANDING

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Introduction

1. Sri Lanka has continued with liberalized market friendly trade policies since 1977 and significant progress has been made towards a competitive trading environment, especially during the past few years. Reducing quantitative restrictions on both imports and exports, rationalizing and simplifying the tariff structure to a three band system, eliminating state monopoly on economic activities, shifting towards a flexibly managed exchange rates system, relaxation of exchange control regulations, finally removing all restrictions on payments for current account transactions and eventually accepting Article VIII status of the IMF Articles of Agreement were among the major achievements recorded in the continued process of trade liberalization.

Legal and Administrative Basis of the Trade Régime

2. The present legal basis for the control of imports and exports lies in the Imports and Exports (Control) Act No. 1 of 1969, as amended by the Amendment Act No. 48 of 1945 and No. 28 of 1987. Under this Act, the Government has the power to prohibit or restrict the importation of any goods and prescribe any conditions relating to imports and exports.

3. The imports control policy is formulated by the Ministry of Trade, Commerce and Food in consultation with the Ministry of Finance and Planning and is subject to the approval of the Cabinet. The Minister of Trade, Commerce and Food is empowered under the Act to formulate and issue regulations in conformity with the objectives and purposes of the Act. The responsibility of administering the regulations rests with the Department of Imports and Exports Control (DOIEC).

4. With the liberalization of imports in 1977, the "Special Import Licence No. 1 of 1977" was published setting out, in a schedule thereto, all the items that could not be imported without a specific licence from the DOIEC. Over the years, some of those items were removed from Licence Control while some other items were brought under Licence Control¹, and this was done by the publication or amendment of a Gazette on each occasion.

5. The Export Regulations published in Government Gazette No. 33/24 of 27 April 1979 have been amended from time to time. At present, the export of four items, viz; (a) coral chanks and shells, (b) timber (c) ivory and ivory products and (d) passenger motor vehicles first registered in Sri Lanka prior to 1 January 1945, only requires Export Licences issued by the DOIEC.

6. Presently, of a total of around 6,000 tariff lines under the HS classification of imports, 280 items are under import licensing requirements only for the reasons of security, health, environment

and public morals and balance of payments. (An updated list of items that could not be imported without a specific licence from this control is given in Annex III in the TPRM Country Report WT/TPR/G/6).

7. The controller of Imports and Exports can refuse granting a licence to any applicant without adducing reasons. The applicant has the right to appeal to the Minister of Trade, Commerce and Food against the Controller's decision.

Tariff Reforms

8. For many years import duties had been used both - as a source of government revenue and a means of influencing the speed and direction of economic growth by protecting selected local industries. However, in line with the objective of promoting trade liberalization, the tariff structure was modified from time to time by a Presidential Tariff Commission which was established for the purpose.

9. A major step in rationalization of the tariff was taken in 1985 when the maximum nominal rate was reduced from 100 to 60 per cent. Subsequently, the Tariff Commission recommended a four band tariff structure with rates of 50, 35, 20 and 10 per cent which was implemented in the budget for 1992. A further tariff change was introduced in 1993 when the maximum nominal tariff was reduced to 45 per cent with accompanying liberalization of items under import control. These rates have been further reduced by the 1995 budget by introducing a three band tariff system 35, 20 and 10 per cent from February, 1995, with the ultimate objective of moving to a lower uniform single tariff by 1997.

10. The overall objective of reduction of import duties was to improve economic activities to generate more employment and make industries more competitive. Sri Lanka is now working towards a lower uniform import duty rate in the near future, incorporating three band tariff now in operation. However, high import duties will continue to be applied on liquor, tobacco, passenger cars and certain luxury goods for revenue and social reasons.

Balance of Payments Situation and Level of Monetary Reserves

11. The overall surplus in the balance of payments in 1994 in Sri Lanka declined sharply due to a variety of reasons such as high demand for imports, deterioration in the terms of trade and reduced inflow of foreign capital. Under the impact of increased expenditure on imports by 16 per cent and a deterioration in the terms of trade by 4.7 per cent, the trade deficit widened from SDR 825 million in 1993 to SDR 1095 million in 1994. The surplus in the services account too declined from SDR 28 million in 1993 to SDR 12 million in 1994 owing to large outflows on account of travel and repatriation of profits and dividends, prompted by lower interest rate differentials between Sri Lanka and international markets, and political uncertainty during the year. Meanwhile, private transfers grew at a slower pace of 10 per cent in 1994 in comparison to a growth of 17 per cent in the previous year. Accordingly, the current account deficit (excluding official transfers) widened by SDR 250 million to SDR 646 million in 1994 raising the current account deficit/GDP ratio from 5.3 per cent in 1993 to 7.9 per cent in 1994.

12. In the meantime, capital account inflows showed a notable moderation in 1994. However, there was a decline in portfolio investments and direct foreign investment from SDR 182 million in 1993 to SDR 131 million in 1994. Similarly, capital inflows to the government too declined from SDR 334 million in 1993 to SDR 283 million in 1994. On the contrary, net private short and long term loan capital inflows increased considerably from SDR 240 million in 1993 to SDR 300 million in 1994 raising the country's external debt. The combined impact of all transactions in the capital account was moderate increase in the non-monetary capital from SDR 612 million to SDR 674 million

between the two years. Consequently, the balance of payments recorded an overall surplus of SDR 173 million in 1994 compared to SDR 375 million in 1993. Following these developments, Sri Lanka's gross external assets rose from SDR 1,544 million at the end of 1993 to SDR 1,792 million at the end of 1994.

13. Although Sri Lanka's external assets rose by 16 per cent in 1994, the overall developments in the balance of payments front clearly underscored the adverse impact of sustained high demand pressure on the balance of payments and hence warrant prudence and caution.

14. Sri Lanka, in the meantime, accepted the obligations under the Article VIII of the Articles of Agreement of the IMF in March 1994 removing all restrictions on current account transactions and allowing free convertibility of Sri Lanka Rupee. This was a major step forward under the ongoing liberalization programme of the country.

15. The details with regard to balance of payments and external assets in Sri Lanka during the recent past are presented in tables I and II respectively in Annex A.

16. It could be observed from Table I of Annex A that the widening gap between exports and imports has been offset by a substantial inflow of remittances by Sri Lankans employed abroad and capital inflows such as foreign grants, foreign loans, foreign direct investments and portfolio investments. These developments in the balance of payments turned the overall balance into a surplus. However, this situation does not represent a strong balance of payments position as they are either contingency liabilities or they may flow outward as easily as they did inward. Relying on a balance of payments surplus on the basis of capital transfers of this nature may prove a destabilizing factor in our economy. In fact, the latest indications suggest that sharp decline in the overall balance from SDR 375 million in 1993 to SDR 173 million in 1994 would continue and hence the overall balance could turn into a deficit in the future.

Balance of Payments Prospects and Expected Movements in Reserves

17. The balance of payments during the first eight months of 1995 indicated an overall deficit of SDR 42 million. Exports grew by 12.5 per cent as compared with 11.2 per cent in the corresponding period of the previous year while imports increased by 7.8 per cent as compared with 7.6 per cent in the corresponding period of the previous year. The gross external assets at the end of August 1995 were sufficient to finance 5.5 months of imports projected for 1995 while the import capacity of external assets were at 6.2 months as at the end August 1994. The current indications are that the overall balance of payment would be in deficit for the year as a whole.

External Debt

18. The external debt of Sri Lanka at the end of 1994 was estimated at SDR 6,089 million recording an increase of SDR 504 million from end 1993 to end 1994. This increase largely reflected the increase in lending to the private sector. Medium and long-term loans of the Government which accounted for 69 per cent of outstanding loans as at end 1994, increased by SDR 69 million mainly on account of concessional assistance extended by Japan, the ADB and the IDA. In 1994, Sri Lanka also received the first tranche under the third year programme of the Enhanced Structural Adjustment Facility arrangement with the IMF amounting to SDR 56 million. With a repayment of SDR 9 million in respect of a loan taken earlier under the Structural Adjustment Facility, the outstanding debt to the IMF increased by SDR 47 million to SDR 423 million at the end of 1994.

19. Debt service payments, which included amortization of medium and long-term loans and interest payments on all foreign loans increased by SDR 15 million or 4 per cent to SDR 372 million in 1994. With earnings from the export of goods and services increasing at a faster rate than the debt service payments during the year, the debt service ratio decreased from 13.8 per cent in 1993 to 13.0 per cent in 1994.

20. The details with regard to external debt and debt service payments are given in the Table III and IV respectively in the Annex B.

Reasons for Continuation of Licensing Restrictions on BOP Consideration

21. The present overall surplus in the BOP is mainly due to the following reasons:

- (a) Private remittances by Sri Lanka's overseas.
- (b) Foreign investments of both direct and portfolio.
- (c) Foreign capital inflows in the form of foreign aid, grants etc.

22. Despite the above, the merchandise account nevertheless has continued to be in deficit right throughout with the gap between the value of imports and exports continuing to widen year after year reaching an all time high of SDR 1,095 million in 1994. (Please see Annex A, Table I).

23. The ongoing war in the country and the heavy expenditure involved towards meeting the cost of war has been a heavy burden on the economy over the years. According to the latest estimates, Sri Lanka's defence expenditure would increase to SDR 402 million in 1995 representing 9 per cent of GDP which is 1.5 per cent higher than the original estimate. The recent tragedy in the oil storage facility with an estimated loss of around SDR 20 million has aggravated this situation. Under the circumstances, Sri Lanka has to utilize its foreign reserves or to depend heavily on foreign assistance which would further deteriorate the balance-of-payments position.

24. The rationale for maintaining import licensing on potatoes, chillies and onions by the Government is primarily to protect a large number of farmers who are scattered around the Island. These farmers who are a very vulnerable segment of the population would find it extremely difficult to survive if import restrictions were to be removed in the face of cheap/subsidized imports from the neighbouring countries. For instance, in the case of chillies, due to the fact that such an item could be stored for long periods extending even up to two years, if free imports were allowed, it would result in the complete ruination of the local chillie industry. Accordingly, until such time local farmers develop improved farming techniques technology etc. and become competitive, it would be necessary that they be provided with an assured income for their economic well being.

25. If not for the ongoing war situation in the North and the East, it would have been possible for Sri Lankan farmers to cultivate these crops in a competitive manner without protection from import licensing.

26. The reason for maintaining licensing requirements for import of other items i.e. wheat and meslin and wheat and meslin flour is simply to protect contractual obligations between the Sri Lanka Government and the Prima Flour Mill. This agreement was signed in 1977 and will expire in 2005.

General Policy in the use of Restrictions for BOP Reasons

27. Sri Lanka will use restrictions for BOP reasons until the BOP position becomes strong. It has no intention of continuing licences for import of these items any longer. However, the present unsettled condition prevailing in the country does not warrant immediate removal of licensing for potatoes, onions and chillies. Consequent on a political settlement to the present crisis in the North and East licensing requirements for potatoes, onions and chillies could be removed. A variable rate of duty (higher rate during the seasons) giving a reasonable protection to the peasants would be imposed on these items with the removal of the licensing.

28. Licensing requirements for import of wheat and meslin and wheat flour and meslin flour will be removed no sooner the agreement between prima Flour Mills and the Government of Sri Lanka is expired.

Annex A

Table I - Balance of Payments
(SDR million)

	1990	1991	1992	1993	1994
1. Merchandise	-518	-726	-740	-825	-1,095
Exports	1,456	1,491	1,745	2,046	2,236
Imports	1,974	2,217	2,485	2,871	3,331
2. Services	-72	-65	-23	28	12
Receipts	391	440	489	535	627
Payments	463	505	513	507	615
3. Goods & Services (1+2)	-590	-791	-763	-797	-1,083
4. Transfers (net)	398	441	457	517	552
Private (net)	268	293	328	402	438
Official (net)	130	148	130	115	115
5. Current Account (3+4)	-192	-350	-306	-281	-531
6. Non Monetary capital (net)	345	475	381	612	674
Direct investment	24	46	86	134	111
Portfolio investment	7	24	18	48	20
Private long term (net)	-33	-18	18	135	216
Private short term (net)	48	35	91	105	182
Govt. long term (net)	299	366	189	190	146
Inflows	392	463	313	334	283
Outflows	93	97	124	144	137
Govt. short term	-	23	-22	-	-
7. Errors and omission	-14	28	59	44	29
8. Overall balance	138	152	133	375	173

Source: Central Bank of Sri Lanka Annual Report 1994.

Table II
External assets of Sri Lanka
(SDR million)

	1990	1991	1992	1993	1994
1. Government	19.3	26.7	23.4	23.4	15.6
2. Central Bank	286.3	475.9	657.9	1,193.7	1,373.3
3. Commercial Banks	296.4	306.2	365.7	326.4	403.3
4. Total	602.0	808.8	1,047.0	1,543.5	1,792.2
5. Gross external assets in months of :					
(a) Merchandise imports	3.7	4.4	5.5	6.5	6.5
(b) Import of goods and services	3.0	3.6	4.2	5.5	5.5

Source: Central Bank of Sri Lanka Annual Report 1994

Annex B

Table III
External Debt
(SDR Million)

	1990	1991	1992	1993	1994
1. Medium & long-term debt	3,822.4	4,246.0	4,624.3	5,059.8	5,381.8
1.1 Government	3,184.4	3,589.0	3,840.8	4,122.7	4,192.0
1.2 Public Corps. with Govt.	136.0	141.0	175.6	246.4	398.3
1.3 Private sector with Govt guarantee	108.0	120.0	129.0	144.0	156.5
1.4 Public Corp. without Govt. guarantee	5.0	3.0	2.4	1.4	0.4
1.5 Pte. sector without Govt. guarantee	101.0	113.0	138.7	169.6	211.9
1.6 IMF drawings	288.0	280.0	337.8	375.7	422.8
2. Short term debt	294.0	250.0	420.6	525.7	707.4
Total (1+2)	4,116.4	4,596.0	5,044.9	5,585.5	6,089.2

Source: Central Bank of Sri Lanka Annual Report 1994.

Table IV
Debt Service Payments
(SDR million)

	1990	1991	1992	1993	1994
1. Deb. Service Payments	328.6	356.3	382.3	357.5	372.4
1.1 Amortization	182.0	200.5	231.0	213.2	211.0
To IMF	31.8	63.6	54.4	18.1	8.9
To others	150.2	136.9	176.6	195.1	202.1
1.2 Interest payments	146.6	155.8	151.3	144.3	161.4
To IMF	20.6	14.7	7.8	5.4	4.9
To others	126.0	141.1	143.5	138.9	156.5
2. Earnings from merchandise exports & services	1,847.0	1,930.7	2,233.7	2,511.3	2,862.4
3. Receipts from merchandise exports, Services & Private transfers	2,143.0	2,253.7	2,622.6	3,034.9	3,361.3
4. Debt Service Ratios					
As percent of 2 above	17.8	18.5	17.1	13.8	13.0
As percent of 3 above	15.3	15.8	14.6	11.8	11.1

Source: Central Bank of Sri Lanka Annual Report 1994.