

GENERAL AGREEMENT ON TARIFFS AND TRADE

RESTRICTED

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REPORT OF THE COMMITTEE ON BALANCE-OF-PAYMENTS RESTRICTIONS ON THE CONSULTATION UNDER ARTICLE XVIII:12(b) WITH CEYLON

1. In accordance with the provisions of Article XVIII:12(b) the Committee conducted the consultation with Ceylon. In conducting the consultation the Committee had before it: (a) the basic document prepared by Ceylon (BOP/64), (b) two background documents dated 9 May and 28 October 1966 prepared by the International Monetary Fund. The consultation was held on 29 November 1966. The present report summarizes the main points discussed during the consultation.

Consultations with the International Monetary Fund

2. Pursuant to the provisions of Article XV of the General Agreement, the International Monetary Fund has been invited to consult with the CONTRACTING PARTIES in connexion with this consultation with Ceylon. In accordance with the agreed procedure the representative of the Fund was invited to make a statement supplementing the Fund's documentation concerning the position of Ceylon. The statement made was as follows:

"With respect of Part I of the Plan for Consultations as is indicated in the supplementary background material dated October 28 1966 which the Fund has supplied there has been a sharp decline in Ceylon's foreign exchange reserves since the beginning of 1966. At the present time the general level of restrictions and the temporary increases of import duties of Ceylon which are under reference do not go beyond the extent necessary to stop a serious decline in its monetary reserves.

"With respect to Parts II and III of the Plan for Consultations, the Fund invites the attention of the CONTRACTING PARTIES to the Executive Board Decision of June 1 1966¹, taken at the conclusion of its most recent Article XIV consultation with Ceylon. The Fund has no additional measures to suggest at this time."

Opening statement of the representative of Ceylon

3. The representative of Ceylon, whose full statement is appended in Annex F, described recent developments in Ceylon's economy and trade. He recalled that continuing deficits had been the main feature in Ceylon's balance of payments since 1957. This had continued through 1964 so that by March 1965 reserves were

¹For the text of this Decision see Annex A.

almost exhausted. By the end of 1965 the situation improved due mainly to a reduction in the volume of imports and a substantial increase in exports of tea, rubber and coconut. Nonetheless, these figures do not reflect the fact that a fair number of import licences were issued in the last quarter of 1965 and consequently payments on this account do not appear in the figures for that year. Furthermore, weather conditions severely limited production of paddy and rice so that foreign exchange expenditures on foodstuffs had to be increased and imports of other consumer goods drastically limited. On the whole **then**, the pressure on external payments continued in 1965, and in fact an acute **shortage** of goods developed towards the end of the year. During the first half of 1966 there was a general decline in the prices of Ceylon's major exports, while there was a sharp rise in the average price of imports, particularly capital goods, resulting in a deficit of Cey Rs 115 million in the merchandise balance.

4. In the domestic sphere, monetary expansion was limited to a comparatively modest level in 1964/65, as compared with previous years by sharply reducing the budget deficit to Cey Rs 40 million and restricting credit to the private sector. The 1965/66 budget called for a high level of capital spending for the continuation of programmes and projects already under way. The deficit was around Cey Rs 80 million. The 1966/67 budget announced in July of this year, reflects the new programmes and policies of the Government. Investments are envisaged in the more productive agricultural and industrial sectors, and restraints have been placed on welfare expenditure. Impetus will be given to infra-structure investments. The deficit should be contained at Cey Rs 57 million. During the period under review the growth of commercial bank credit to the private sector has been controlled for all but productive purposes. Government revenues have increased through higher import duties, increased excise taxes and a general tightening of the tax administration, higher profits from the public sector corporations and a revision of the turnover tax have also contributed.

5. These monetary and fiscal measures have been complemented by others designed to transform the outlook of Ceylon's economy. Disputes over compensation payments to oil companies have been settled. The moratorium imposed in August 1964 on remittance of profits and dividends has been relaxed. The climate for foreign investments has been improved by the issuance of a Government White Paper on the matter. Emphasis has been placed on the production of rice, chillies, onions, meat, milk and milk products and fish, all goods which are at present largely imported. A further rationalization of public sector industries is envisaged. In the traditional agricultural export field, schemes for planting and replanting tea, rubber and coconut are in process. He further added that import policy was now formulated by the Ministry of State and not by the Ministry of Commerce and Trade as set out in BOP/64.

6. Even though the measures taken by the Government of Ceylon are destined to maximize domestic output, both for export and internal consumption, in order to ease the pressure on payments, it would be difficult to anticipate any major relaxation in the present scale of import and exchange restrictions in the absence of improvement in the terms of trade and the quantum of foreign aid.

Balance-of-payments position and prospects

7. The Committee thanked the representative of Ceylon for his detailed statement and expressed understanding of the difficulties with which Ceylon was currently faced. The Committee expressed the hope that the various measures taken by Ceylon would prove effective in redressing the unfavourable development of the country's external position.

8. In answer to a question whether any further consideration had been given to the proposal, contained in the 1966/67 budget speech, that foreign exchange savings made possible by increased local production and purchase of rice, could be made available, on payment of a special import licence fee, for liberalized imports of consumer goods and raw materials, the representative of Ceylon stated that no firm decision had been taken as to the amount that would be made available in this manner. In this respect, proposals to impose a fee on imports of textiles and certain imports of tools to finance production of rice were under study in the Ministry of State.

9. Members of the Committee inquired whether the Government of Ceylon had set itself some sort of target in the future for its investments as a percentage of the gross national product and, in that context, whether the import quota system was operated to encourage the import of items vital to industrial development in specific sectors. The representative of Ceylon replied that no macroeconomic target had been set, and that only particular sector projects were currently being undertaken. Provision was also being made for increased import allocations to the private sector which hitherto had been operating below capacity. In this regard the recommendations made by a recent mission of the International Bank for Reconstruction and Development had been taken into account. In the process of establishing annual quotas due consideration was given to these projects. In the last budget, for example, the emphasis was put on imports of raw materials and machinery.

10. In answer to a question, as to the relationship between special sources of supply and rising costs of capital goods, the representative of Ceylon said that increased cost of capital goods had to be taken into account. Even though as a rule purchases were made from the cheapest sources, with due regard to quality specifications and other considerations, certain sources might be preferred because of special credit terms and facilities.

11. The representative of Ceylon explained, in reply to a question, that in the last few months about seventeen specific private investment projects had been approved by his Government in response to the new policies to encourage investments embodied in the White Paper on foreign investment, which covered areas of investment, joint participation in local capital, tax concessions, facilities for the remittance of earnings and repatriation of capital, etc.

II. Alternative measures to restore equilibrium

12. The Committee expressed its appreciation of the efforts being made by Ceylon in the fiscal and monetary field to contain inflation, and also welcomed the more realistic attitude being taken by Ceylon in the administration of its quota allocations.

13. In answer to a question relative to the principles guiding the work of the Committee reviewing Ceylon's tariff, the representative of Ceylon said that in general low duties would be applied to food items and goods having a bearing on the cost of living; on intermediate and consumer goods, tariffs would be proportionately higher taking into account Ceylon's development needs. Work on this is expected to be completed early in 1967. He noted the wish of a member of the Committee that the tariff restructuring be as liberal as possible in view of the significance of the tariff as a long-term instrument of policy.

III. System and methods of the restrictions

14. Several members of the Committee inquired into the nature and effects of the bilateral agreements signed by Ceylon. The representative of Ceylon explained that there were different types of agreements. Some were of a permissive nature simply listing products with no import or export targets set; others like the bilateral agreement with China were negotiated annually with prices and levels of imports established each year. Yet another type of which the new agreement concluded in 1966 with Iran is an example, is permissive and based on a simple exchange of letters containing trade intentions, without quota or payments provisions. In reply to a question, the representative of Ceylon said that, in his view, permissive agreements were not necessarily superior to contractual agreements in serving economic development, and that, in certain circumstances, yearly negotiated contractual agreements were certainly beneficial. Thus in one such agreement prices of Ceylon's exports were above world prices and import prices paid by Ceylon were equal to or below world prices. To a further question, he replied that in some of these agreements, prices were set in bilateral consultations taking into account all relevant elements, including world prices. Import trade through bilateral agreements had increased in recent years due mainly to purchases by governmental organizations.

15. The representative of Ceylon explained, in reply to a question, that although only registered Ceylonese traders are permitted to import from the "Ceylonized area" countries or to import certain specified products from any source, those registered importers of specified products need not be the same as those from the "Ceylonized area" countries.

16. In response to a question, the delegate of Ceylon stated that for merchandise trade statistics his Government relies mainly on Central Bank figures, which indicate actual payments, rather than the Customs Returns. There is a wide discrepancy between the import figures of foodstuffs of the Food Commissioner and those shown in the Customs Return as being imported on his account and action is being taken to correlate them.

General

17. The Committee thanked the representative of Ceylon for the frank and co-operative manner in which he had engaged in the consultation and expressed understanding of the problems with which Ceylon was confronted. The Committee expressed the hope that in its current study on the tariff structure the Government of Ceylon would be guided by long-term development interests. The Committee also urged that Ceylon reduce its reliance on bilateral trade agreements.

18. The representative of Ceylon thanked the Committee for the understanding and sympathetic manner with which the consultation had been conducted. He stated that he would bring the views and suggestions made by the members of the Committee to the attention of his Government, which would give them careful consideration.

ANNEX A

INTERNATIONAL MONETARY FUND EXECUTIVE BOARD DECISION
TAKEN AT THE CONCLUSION OF THE FUND'S CONSULTATION
WITH CEYLON ON 1 JUNE 1966

1. This decision is taken by the Executive Directors in concluding the 1965 consultation with Ceylon, pursuant to Article XIV, Section 4, of the Articles of Agreement.
2. Ceylon's rate of growth of real output slowed down from 4.5 per cent in 1964 to only 2 per cent in 1965. This was largely attributable to adverse weather conditions that resulted in a sharp drop in the production of paddy and coconuts. Industrial production was affected by the shortage of raw materials and machine parts. With population increasing at 2.4 per cent, per capita income fell in 1965.
3. The rate of increase in money supply slowed down in 1965 owing to slackening of expansion of bank credit to the private sector and the reduction in the budget deficit requiring bank financing. The Fund urges vigorous pursuit of a policy of increasing development outlays, restraining other government expenditures and increasing revenues.
4. The balance of payments position improved in 1965 and foreign exchange reserves increased for the first time since 1956. Nevertheless, the Fund believes that additional measures are necessary to bring about a better allocation of resources and thereby a basic improvement in the payments situation.
5. Restrictions on imports and import payments continued to be tight. The Fund notes the relaxation of the moratorium on remittances of profits and dividends and the removal of the foreign exchange tax. The Fund urges the early removal of the moratorium and hopes that the reliance on bilateral payments agreements will be reduced.

ANNEX BOpening Statement by Representative of Ceylon

You will recall that at our last consultation with the Balance-of-Payments Committee, the Ceylon delegation referred to the considerable strains on her external accounts which had led to a decline in external reserves, and the need to impose and intensify import restrictions in order to safeguard the reserves. Drastic restrictions of imports had to be introduced to relieve the severe pressures on her external payments account. In 1964 the terms of trade which had declined particularly sharply in the previous year by 9 per cent dropped further by 3 per cent. In spite of these restrictions Ceylon experienced a deficit in her balance of payments on current account in 1964 resulting in a decline of Cey Rs 51 million in external assets, and a rise of Cey Rs 40 million in short-term external liabilities. (Increases in world prices for food imports, particularly sugar, contributed to payments difficulties in 1964.) Continuing deficits have been the dominant feature in Ceylon's balance of payments since 1957. By March 1965 the adverse external balance had brought reserves almost to the point of exhaustion. I am glad to say that by the end of the year 1965 this trend was changed, and the deficit on merchandise account was reduced to only Cey Rs 5 million. An improvement in both the merchandise and invisible accounts helped to transform the current account of deficit from Cey Rs 160 million in 1964 to a surplus of Cey Rs 47 million. The basic balance which reflects the country's net external position on both commercial and long-term capital transactions showed a surplus of Cey Rs 106 million last year, as compared with a deficit of Cey Rs 90 million in 1964. Consequently Ceylon's total external assets increased by Cey Rs 89 million to Cey Rs 440 million, as compared with a decline of Cey Rs 111 million in 1964 and continuous declines in previous years. This increase in the external assets also reflects net drawings amounting to Cey Rs 53.4 million from the International Monetary Fund.

The comparatively favourable picture of the trade position of 1965 is the result of a fall in the volume of imports, combined with a substantial increase in the volume of exports. Production for export was a record. Tea and rubber output responded well to improvements in yields and replanting, although there were slight declines in prices. Coconut was affected by adverse weather conditions, but the decline in the export volume was partly compensated for by an increase in prices. Payments for imports of rice and flour increased in 1965, but there was a substantial fall in payments for sugar. The average price index of imports, which in 1963 and 1964 had risen by 10 points and 2 points respectively, increased a further 2 points (109) mainly due to a rise in prices of investment goods, but the terms of trade improved slightly by 2 points in contrast to the declines in 1963 and 1964.

The favourable trade situation requires to be modified, as a fair proportion of the import licences were issued in the last quarter of 1965, and payments on this account were not fully reflected in the accounts for the year. Paddy production was seriously affected, both by a cyclone early in the year (which also damaged the fishing fleet) and a prolonged drought. Output of rice fell sharply, by as much as 30 per cent, and foreign exchange expenditure on the import of essential foodstuffs had to be increased, making it necessary to curtail imports on other consumer goods, including textiles rather drastically.

On balance, therefore, the pressure on external payments continued in 1965. In fact acute shortages of goods developed towards the end of the year, both from the inadequate level of domestic production, and from the reduction in imports resulting in continued pressures on the domestic price level. Despite the improvement in the internal financial situation, 1965 was a disappointing year, due substantially to factors beyond Ceylon's control. It is estimated that but for adverse weather conditions particularly the prolonged drought, output might have increased by perhaps 4 per cent in real terms. Instead, the gross national product increased by only 2 per cent as compared with 4.4 per cent in 1964.

During the first half of 1966 there was an all round decline in the prices of Ceylon's major exports, although output, particularly of tea and rubber, increased as compared with the first half of 1965. Here again the factors behind the poor export performance this year are largely attributable to factors beyond Ceylon's control. On the one hand drought conditions persisted, while external market forces combined to depress prices. The principal elements responsible for a weakening of tea prices were the general increase in world supply, combined with a reduction in the volume of imports into the major consuming countries. A substantial fall in prices of coconut products resulted from the increase in output of competing oils, particularly soyabean.

Import payments have remained high with significant increases in the volume of food and drink imports, and of imports of investment goods. There has been a sharp rise in the average prices of imports, particularly of capital goods. As a result, the merchandise balance in the first half of this year showed a deficit of Cey Rs 113 million, as compared with a deficit of only Cey Rs 56 million for the corresponding period of last year. Ceylon's deficit on invisibles at Cey Rs 5 million was approximately the same as in 1965. The basic balance showed a deficit of Cey Rs 97 million, and was financed primarily by drawing down external assets to the extent of Cey Rs 77 million, and by accumulating short-term liabilities totalling Cey Rs 20 million. This decline reflects payments for imports made towards the end of 1965, as I mentioned earlier, and some liabilities in respect of licences issued in the first quarter of this year. There is every prospect that the balance-of-payments will in the remaining months of 1966 continue to be subject to severe pressures.

In the domestic sphere, monetary expansion was held down to a comparatively modest level in 1964/65 by the sharp reduction in the expansionary impact of the Government budget, and by a reduction of credit to the private sector. You will recall that budgetary deficits in the past had been large (round Cey Rs 200 million) but had been contained, and there had been no continued acceleration in the scale of deficits. The budget for 1964/65, however, marked a distinct departure from the past with the expansionary deficit being reduced to only Cey Rs 40 million. For one thing the net cash deficit was somewhat smaller than expected, but more significantly there was greater borrowing from domestic non-bank sources whose available funds have increased considerably in recent years, notably the Insurance Corporation which has undergone a period of rapid expansion. Funds from the Employees Provident Fund and other pension funds, and from the Savings Institutions, have become available in increasing measure. The overall effect of this change in the volume of pattern of financing has been to mobilize savings.

The 1965/66 budget provided for a high level of capital spending, but largely represented provision for the continuation of programmes and projects already started. In view of the increases in purchases by Government of paddy in the guaranteed price scheme, however, the unfinanced gap was higher than the previous year, at around Cey Rs 80 million. The budget for 1966/67 announced in July this year, which reflects the new programmes and policies of the Government, is intended to provide a new impetus to development and growth of the economy. The major portion of the additional envisaged capital provision will be diverted to more productive agricultural and industrial sectors, and to economic overheads, including power, roads, railways, civil aviation and ports. Restraints have been placed on welfare expenditure, including health and education. The expansionary deficit is being contained at Cey Rs 57 million to ensure that overall monetary expansion is no more than justified by the annual growth of output.

During the period under review the growth of commercial bank credit to the private sector has been controlled for all but productive purposes. There is also an overall limit on the expansion of the domestic assets of the Central Bank. A rise in the bank rate also led to a general increase in commercial bank lending rates. Another measure was the introduction of marginal reserve requirements for the Peoples Bank which had hitherto been exempt. The purpose of these measures was to reverse, without a reduction in the level of economic activity, the tide of expansionary financing which had reached excessive proportions in the past. Revenues have been increased despite a reduction in the excessively high rates in income and private taxes, largely through higher import duties, increased excise taxes, a general tightening of the tax administration, and an unexpectedly large collection of income taxes through an amnesty. There were higher contributions from the profits of public sector

corporations, and a revision of the turnover tax to broaden the basis of taxation so that a larger part of the community would contribute to revenue. In 1966/67 direct taxes have not been touched, as the Government has set up an Income Tax Commission to investigate the entire structure of the tax system in Ceylon.

The monetary and fiscal measures were accompanied by other measures designed to transform the outlook for the Ceylon economy. As you know the dispute over the question of compensation payments to oil companies was settled by the present Government on assuming office. The moratorium imposed in August 1964 on the remittance of profits and dividends has been relaxed, with a view to its complete elimination as early as the foreign exchange situation would permit. The climate for private foreign investment has been further improved by the issue of a definitive White Paper outlining the Government's policies and objectives in this field. This Paper covers areas of investment, joint participation in local capital, tax concessions, facilities for the remittance of earnings and repatriation of capital, etc.

Planning activity has been strengthened with the establishment of a new Ministry of Planning and Economic Affairs. The emphasis is initially on sector programming as against overall macro economic planning. These programmes have been appraised by successive teams from the World Bank. A scheme of priorities has been followed for development. New emphasis has been placed on the growth of the domestic agricultural sector. Special efforts are being made to produce agricultural goods which are at present largely imported. The most noteworthy examples are rice which has enjoyed considerable success up to now with marked improvement in yields; chillies; onions and the production of meat; milk and milk products and fish. The programme for industry envisages the further rationalization of public sector industries, a number of which are beginning to show profits, and the provision of foreign exchange allocations for private sector investment.

In the agricultural export field the traditional sector is being strengthened by subsidiary schemes for planting and re-planting tea, rubber and coconut. The impact of the enlarged programmes are not likely to be felt immediately. Of immediate interest is the proposed rehabilitation scheme for tea factories and machinery, intended to improve tea quality in the expectation that prices for Ceylon teas would improve.

The Government has taken major steps to increase domestic production, and the monetary fiscal policies have been geared to maximizing domestic output in order to limit the pressures on payments. It would, however, be difficult to anticipate any major relaxation in the present scale of import and exchange restrictions in the absence of the substantial improvement in the terms of trade and the quantum of foreign aid.

This consultation is also intended to cover the consultation required under the waiver granted to Ceylon to maintain import duties on certain items higher than those bound in Ceylon's GATT Schedule. This waiver expires at the end of this year, and the Government now seeks to obtain a further waiver for two years in view of the circumstances to which I have referred, which have necessitated the maintenance of substantial import restrictions. I must mention, however, that a Committee is currently sitting in Colombo to review the entire tariff structure, and consideration is being given to the possibility of restoring the duties, on bound items to their bound levels. In conclusion I would like to emphasize that the Government has not confined its actions to import restrictions, but has taken parallel steps in the monetary and fiscal field to restrain internal demand. These measures would have had greater success if external conditions and weather conditions had been more favourable. The continuing deterioration in prices for Ceylon's major export products makes it extremely difficult to implement effective monetary and fiscal policies.