

GENERAL AGREEMENT ON TARIFFS AND TRADE

RESTRICTED

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Committee on Balance-of-Payments Restrictions

REPORT ON THE CONSULTATION UNDER ARTICLE XVIII:12(b) WITH CEYLON

1. In accordance with its terms of reference, the Committee has conducted a consultation with Ceylon under paragraph 12(b) of Article XVIII. The Committee had before it the following documents: (a) a basic document for the consultation prepared by Ceylon (BOP/115) and supplementary information supplied by the Government of Ceylon for the consultation (Spec(71)36); (b) the Executive Board Decision taken on 17 March 1971 at the conclusion of the International Monetary Fund's consultation with Ceylon; and (c) a background paper dated 2 March 1971 provided by the International Monetary Fund.

2. In conducting the consultation the Committee followed the plan for consultations recommended by the CONTRACTING PARTIES (L/3388). The consultation was held on 22 June 1971. This report summarizes the main points of the discussion.

Consultation with the International Monetary Fund

3. Pursuant to the provisions of Article XV of the General Agreement, the International Monetary Fund had been invited to consult with the CONTRACTING PARTIES in connexion with this consultation with Ceylon. In accordance with the agreed procedures, the representative of the Fund made a statement concerning the position of Ceylon, as follows:

"The Fund invites the attention of the CONTRACTING PARTIES to the Executive Board decision of March 17, 1971 taken at the conclusion of its most recent Article XIV consultation with Ceylon, and particularly to paragraphs 2 and 4 which read as follows:

'2. Ceylon is at present experiencing a difficult economic situation. The rate of growth of the economy decelerated in both 1969 and 1970 but was still generally satisfactory. Bank credit expansion, despite some slowing down in 1970, continued to be rapid. Prices increased further in 1970 although the rate of increase slowed down in the latter part of the year. Above all, the external payments position is critical, liquid foreign exchange reserves being very small and substantial short-term liabilities having accumulated.

'4. Exchange restrictions have been severely tightened. The exchange rate system remains unchanged in structure since the last consultation but the scope of the certificate market has been widened, especially on the payments side. The Fund emphasizes the need for

further measures to strengthen the balance of payments and welcomes the intention of the Ceylonese authorities to study what further changes in the exchange policies are necessary.'

"At the present time, the general level of restrictions of Ceylon which are under referencè does not go beyond the extent necessary to achieve a reasonable rate of increase in its monetary reserves."

Opening statement by the representative of Ceylon

4. The representative of Ceylon made an opening statement, the full text of which is reproduced in the annex, in which he recalled that Ceylon's foreign exchange difficulties had existed for over a decade. Apart from two very short periods of prosperity in 1951 and again in 1954-1956, external assets had continued to decline steadily until today. Since 1957, Ceylon's current payments to the rest of the world had exceeded current receipts. One of the major factors behind the adverse payments situation was the unfavourable price trends of Ceylon's major exports. The terms of trade in recent years over the ten-year period ending 1970 had been consistently adverse to Ceylon. Among the factors which had contributed to this worsening of the terms of trade were (a) the sharp rise in the prices of imports together with the rise in freight rates in recent years; (b) the relatively poor prices received for two of Ceylon's major exports, viz tea and rubber, and (c) the higher prices which were normally associated with imports obtained on credit terms or under aid arrangements. Imports and exchange controls therefore had to be introduced, and these had been maintained up to now with a brief period of liberalization for certain categories of imports under the foreign exchange entitlement certificates scheme from May 1968 to August 1970. At that time a sizable part of the import trade had been placed under open general licence subject to a premium rate of exchange. However, the continued deterioration of the balance of payments of Ceylon and the poor prospects for any improvements in the near future left the Government with no other option but to suspend the open general licence scheme in May 1970, pending a review of the foreign exchange position. In August 1970, the scheme was abolished.

5. The representative of Ceylon went on to describe some of the financial and monetary policy measures taken by the Government. He gave a brief picture of some of the steps the Government was taking in the budgetary and fiscal fields and explained the relation between the balance-of-payments considerations and the formulation of the country's industrial policy and its import substitution programme in agriculture. He concluded by recalling the reasons for the fundamental imbalance in Ceylon's balance of payments which was basically the result of expenditure outstripping available resources. In this context, Ceylon's heavy dependence on three products for its foreign exchange earnings and the persistent deterioration in prices for these products made it very difficult to implement effective monetary and fiscal policies. A concerted national effort maintained over a long period would be necessary in order to place the balance of payments on a sound footing.

Balance-of-payments position and prospects

6. Members of the Committee expressed sympathy with the Government and people of Ceylon for the serious economic situation they faced at present and, in particular, the critical external payments position. The foreign exchange reserves had declined to a very low level while short-term liabilities had grown to a disproportionately high level so that Ceylon was obliged last year to further tighten the import restrictions through the abolition of the open general licences. On the other hand, it might be noted that there had been some improvement in the trade balance owing to an increase in exports and some reduction in imports. Other encouraging factors included the rising tendency of rubber and tea prices in recent months, the increase in domestic production of rice and essential foodstuffs and the availability of a greater variety and volume of processed export goods. It was to be hoped that these developments would eventually lead to further improvements in the balance of trade and would contribute to lessening the pressures on the balance of payments so as to permit the reduction and removal of import restrictions.

7. Noting that the improvement in the trade balance in 1970 had been based on an increase in exports as well as a decrease in imports, a member of the Committee wished to know the factors responsible for these changes - whether, for example, the increase in the value of total exports was attributable to any rise in export prices or whether there had been an increase in the volume of goods shipped; to what extent this development was attributable to the various export incentive measures, notably the exchange certificate system; whether any additional measures in this domain were envisaged, and whether the diminution of imports had been brought about by a tightening of the import restrictions. The representative of Ceylon replied that the reduction in the trade deficit in 1970 had been due partly to an increase in the volume of exports coupled with some improvement in the prices of tea and coconut products, and partly resulted from a reduction of imports, which had been found necessary in order to avoid a further depletion of the meagre exchange reserves. As for the expansion of exports, steps had been taken by the Government of Ceylon to diversify both agricultural and industrial production and exports. For the foreseeable future, however, exports would continue to comprise overwhelmingly the three traditional commodities - tea, rubber and coconut products - which at present constituted about 90 per cent of total exports. Certain other agricultural products would add up to a further 5 or 6 per cent. Such industrial production as had been developed so far had served mainly to meet domestic demand, and helped to relieve some pressure on import demand; exports of industrial products were still negligible. On the other hand, import substitution had made greater headway in the agricultural sector so much so that 80 per cent of the country's rice requirement was now met by domestic production. The attainment of self-sufficiency in foodstuffs was one of the major economic objectives in Ceylon.

8. In response to questions concerning the balance-of-payments prospects in 1971 and in subsequent years, the representative of Ceylon pointed out that Ceylon's balance of trade depended predominantly on the world market conditions for the three products on which the country mainly depended for its export earnings. The situation was therefore a precarious one and a reliable forecast of the situation

for 1971 as a whole, or indeed for any particular year was difficult. As regards longer-term prospects - the situation beyond 1971 or 1972 - the representative of Ceylon stressed that the balance-of-payments difficulties faced by Ceylon actually reflected certain fundamental structural problems. About 90 per cent of the country's foreign exchange earnings derived from three commodities, all of which were subject to wide price fluctuations. The economy also depended heavily on imports in regard to certain essential foodstuffs and raw materials for industry. While every effort was being made to remedy these structural weaknesses, quick results were not to be expected. In the meantime, the situation was aggravated by the continued worsening of the terms of trade, mainly caused by rising prices of imports, which between 1967 and 1970 had risen by about 40 per cent. Ceylon's export earnings from tea, for example, had in the twenty years between 1950 and 1970, risen from \$158 million to \$188 million only, in spite of a 60 per cent increase in the volume of exports. Added to this was the population explosion. Unless and until these fundamental problems were resolved it was difficult to be optimistic or confident in predicting further balance-of-payments prospects.

Internal measures to restore equilibrium

9. A member observed that Ceylon's situation was that of a typical developing country relying on the export of a limited range of tropical products which were subject to rapid and frequent variations in prices. The instability of the markets for such products was a well-known fact and its solution would seem to lie in the conclusion of international commodity arrangements such as had been done in respect of certain other primary commodities. The difficulties created by the falling prices of such export commodities were in such cases further aggravated by the world-wide inflation which had tended to raise the prices of industrial products, including capital equipment needed by countries such as Ceylon which were in the process of development. The representative of Ceylon recalled that there had indeed been consultations among tea-producing countries with a view to taking collective measures to ensure market stability for this product, but the attempt at concluding an international tea agreement had so far not been successful.

10. A member of the Committee expressed the view that while Ceylon's difficulties mainly arose from external developments such as the falling prices of the major exports, which were beyond its control, and while the use of import restrictions was indeed necessary in present circumstances, it was nevertheless important for the Government of Ceylon to take appropriate action designed to restore internal stability, to diversify exports and to reduce reliance on imports of essential foodstuffs. The representative of Ceylon, requested to comment on any further action that his Government might have planned along these lines, reaffirmed his Government's determination to encourage the establishment and development of export-oriented industries, and to maximize import substitution in regard to essential foodstuffs.

11. A member of the Committee asked whether the Paddy Marketing Board procurement price was sufficiently high to encourage domestic production and whether a high price for rice might not overburden the Government budget and consequently be detrimental to financial stability. The representative of Ceylon explained that

food imports now represented about 50 per cent of the country's total imports and naturally the Government placed great emphasis on increasing domestic food production. It was trying to achieve self-sufficiency in rice and other subsidiary foodstuffs and this would greatly contribute to solving the country's balance-of-payments problem. Added to this was the need to provide employment opportunities for the growing population in a country with an extremely limited industrial base, where outlet for excess manpower had to be sought in the agricultural sector. The Paddy Marketing Board was intended to serve several important purposes, one of which was to ensure that the guaranteed price in fact reached the producer.

12. A member of the Committee drew attention to the fact that the new import restrictions introduced in 1970 appeared to have affected more severely capital goods and materials needed by industry than foodstuffs and consumer goods, imports of which in fact had increased. This would seem to deviate from the policy of fostering investment to diversify exports and increase the production of import substitutes. The representative of Ceylon replied that Ceylon relied predominantly on imports of food and certain essential consumer goods and that imports of such urgently needed products could not easily be reduced without creating undue hardship and serious social problems.

13. Members of the Committee welcomed Ceylon's intention to diversify its exports. In response to questions concerning specific measures taken in this area, the representative of Ceylon said that in the agricultural sector one of the objectives pursued was to reduce the predominance of the three major export commodities and to shift the relative emphasis onto a wider range of "minor commodities". In fact, this was the main purpose of the exchange certificate system introduced in 1968. As a result of this measure exports of "minor commodities" had shown significant growth - from \$25 million in 1968 to \$27 million in 1969 and to \$33.5 million in 1970. In the industrial sector, priority was given to industries which were export-oriented; priority was also accorded to industries which were based wholly on locally produced raw materials or which had a specified minimum local raw material content, provided the goods produced were of an essential nature. In order to promote exports, care was taken to ensure that domestic production was sufficiently competitive in terms of quality and price.

14. One member of the Committee expressed the view that while the imposition of new restrictions was necessary, care should specially be taken not unduly to damage traditional trading links which, once severed, might be difficult to repair. He therefore wished to know if any steps were being taken by Ceylon to retain the confidence of her traditional trading partners and to ensure that the restrictions on trade and investment would be removed as soon as there was no further need for them. The representative of Ceylon assured the Committee that his Government was fully aware of the importance of preserving traditional trade links and that there certainly was no desire to diminish the close trade relations that Ceylon had traditionally maintained with western countries.

15. Attention was drawn to the net outflow of private capital which seemed to have persisted during the past decade, and the representative of Ceylon was requested to comment on any measures taken to improve the conditions for foreign

investment in the country or otherwise to stimulate the inflow of investment capital. The representative of Ceylon stated that this question was under active consideration by his Government and that a report possibly containing concrete proposals was expected shortly.

System and methods of the restrictions and effects of the restrictions

16. Members of the Committee reiterated their understanding of the circumstances which had necessitated the introduction of the new import restrictions last year, and expressed hope that the Government of Ceylon would relax restrictive measures when the balance-of-payments situation permitted.

17. In answer to a question the representative of Ceylon stated that the size of each quota allocation was determined on the basis of essentiality. After an importer received a specific quota, however, he was free to import any product falling within the corresponding allocation. All relevant information regarding imports and the regulations governing such imports are published in the Government Gazettes. Since allocations granted to importers vary according to the foreign exchange available and since variations do occur frequently, no overall amount is published. No particular amount is allocated to each country as importers are free to import goods from the cheapest sources on licences issued. Only licences issued against loan allocations require that goods be imported from sources from which funds are made available. Quotas are determined on a six-monthly basis. Importers are not required to apply afresh for subsequent six-monthly periods once they have become entitled to an allocation. The available allocation against each quota is proportionately distributed among importers registered for the import of goods under quotas based on past performance. If the individual entitlement is meagre a minimum may be fixed depending on the type of item to be imported. In the case of certain licences for loan-financed items the minimum allocations are specified by the donor country. The names of importers to whom licences have been allocated are readily made available.

18. Several members of the Committee noted the extensive use of State trading by Ceylon and expressed their concern over its possible effects on the country's trade relations with other contracting parties. They asked whether the State-trading corporations were governed by any rigid plans in regard to the quantities and sources of their purchases, whether any such regulations and decisions were accessible to the public, whether operation of the State-trading operations fully conformed to the provisions of Article XVII of the General Agreement and whether any data on the quantity or value of goods handled by these State-trading corporations were available. The representative of Ceylon replied that import by the State-trading corporations as well as by the private sector, was subject to foreign exchange allocation determined in the light of the foreign exchange resources available. In the view of his Government the requirements of Article XVII of the General Agreement were fully complied with.

19. In reply to a question the representative of Ceylon stated that the licences issued to the Sri Lanka State Trading (General) Corporation for 1971 amounted to Cey Rs 60 million. This figure was only a small proportion of the total worth

of import licences issued. Like the other State-trading corporations Sri Lanka was also subject to exchange restrictions, and granted a quota allocation for imports. The Sri Lanka State Trading (General) Corporation imported goods itself as well as through private traders (e.g. drugs and pharmaceutical products).

20. One member of the Committee enquired whether the quota allocations to State-trading corporations were granted without reference to sources of supply. The representative of Ceylon confirmed that there was no discrimination as to the source of supply. The submission of tenders was open to all prospective suppliers on a competitive basis.

21. Noting that the State-trading system had as its stated objectives to stabilize prices, to ensure regular adequate supplies of goods and to conserve foreign exchange through bulk purchases, a member asked whether the system was expected to work efficiently enough to guarantee the achievement of these goals. The representative of Ceylon thought that there was no reason to doubt that these objectives would generally be achieved.

22. A member of the Committee expressed satisfaction over the tariff reform carried out in October 1970, but pointed out that its effect would be fully felt only upon a relaxation of the present quantitative import restrictions. Asked in this context whether the Government of Ceylon intended to eliminate any of these quotas in the near future, the representative of Ceylon referred to the uncertainties which preclude any prediction in this regard, but reaffirmed his Government's intention to relax the restrictions as soon as the balance-of-payments position permitted.

23. In reply to a question, the Representative of Ceylon explained that all imports involving the payment of foreign exchange were now divided into two categories, Category "A" Imports and Category "B" Imports for both of which exchange allocations were issued. For goods not listed on the annexes of document BOP/115 applications for licences would be allotted to one category or the other.

24. Referring to the items of goods imported by the Sri Lanka Trading (General) Corporation, one member of the Committee sought more detailed information on the goods listed as "miscellaneous items". The representative of Ceylon stated that these miscellaneous items included tyres and tubes, base metals, window glass, photographic material and motor spares. A full list of these items had been published in the Government Gazette and had been circulated to all foreign missions in Ceylon.

25. In reply to questions on Ceylon's bilateral trade arrangements, the representative of Ceylon stated that in his Government's view, these bilateral arrangements were of benefit to Ceylon. Some of these bilateral arrangements were an essential means of trading without which no trade could take place with some of the East European and Middle East countries. On the other hand, it should also be noted that the trade covered by these arrangements was only a small percentage of Ceylon's total trade. In some cases, the trade balance under these bilateral arrangements was in Ceylon's favour and the settlement of these balances

was usually reached through periodic negotiations with the country concerned. This was, however, not always possible, since the situation was subject to continuous changes.

26. Referring to the exchange certificate system, a member of the Committee asked what the prospects were for a unification of Ceylon's rates. The representative of Ceylon stated that the FECS scheme had the temporary approval of the IMF. The question of the duration of the scheme was a matter of Government policy decision.

Conclusions

27. The Committee recognized that the present balance-of-payments difficulties of Ceylon warranted the use of quantitative restrictions on imports as provided for under Article XVIII:B. It urged Ceylon to consider additional measures to increase foreign exchange earnings, particularly through promotion and diversification of exports, and expressed the hope that the recent improvement in the balance of trade would continue so as to enable some easing of the stringent restrictions placed on imports essential for the further development of the economy.

ANNEX

Opening Statement by the Representative of Ceylon

Ceylon's foreign exchange difficulties have existed for over a decade and the Ceylon Government has been compelled to maintain restrictions with varying degrees of intensity on balance-of-payments grounds. Consultations have been held periodically in terms of Article XVIII:12(b); the last occasion when such consultations were held was on 1 July 1969.

The basic information for the present consultations is set out in document BOP/115. This document is supplemented by an analysis of the balance-of-payments position of Ceylon in document Spec(71)36. I shall, as far as possible, try to avoid going over the information set out in these two documents as these have been circulated to the members of the Working Party well in advance of this meeting.

Ceylon's foreign trade in the post-war period has had two short-lived phases of prosperity. The first during the years of the Korean War boom in 1951 when rubber prices shot up sharply, and the second in 1954/56 when tea prices rose pushing up our external assets to a level of Cey Rs 1,194 million in 1956. Thereafter, external assets have continued to decline steadily up to the present time.

Since 1957, Ceylon's current payments to the rest of the world have exceeded current receipts. One of the major factors behind the adverse payments situation has been the unfavourable price trends of Ceylon's major exports. The terms of trade over the ten-year period ending 1970 have been consistently against Ceylon. They have sharply deteriorated since 1965.

The balance-of-payments problem created by the adverse movement in the terms of trade may, to some extent, be estimated from the relation between the current account balance and its effect on the terms of trade as indicated in the table at page 6 in Spec(71)36. In almost every year since 1965, when the impact of the fall in terms of trade was greatest, the amount of exchange "lost" to Ceylon by the unfavourable movement in the terms of trade was greater than the deficit realized in the current account. In other words, if prices of exports and imports, had remained at 1959 levels, the actual volume of exports and imports, which took place between 1965 to 1969, would in fact have resulted in surpluses rather than deficits in the current account. If the terms of trade had remained favourable, Ceylon would have been able to finance a considerable part of its development programme without external assistance.

Due to the lack of adequate foreign exchange resources caused by the adverse terms of trade, Ceylon was compelled to resort to borrowing from abroad to finance its essential imports between 1966 and 1970. Various methods were used to bridge the resource gap. These include commodity aid, International Monetary Fund drawings and suppliers' credits and short-term credits, resulting in the

accumulation of a substantial foreign debt. Thus, Ceylon now has to cope not only with the problems arising from continuing adverse terms of trade, but also with the problems arising from foreign debt.

The more significant factors which have contributed to the worsening of the terms of trade are:

- (1) the sharp rise in the prices of imports together with the rise in freight rates in recent years;
- (2) the relatively poor prices received for two of Ceylon's major exports, viz tea and rubber;
- (3) the higher prices which are normally associated with imports obtained on credit terms or under aid arrangements.

The deficits in the current account of the balance of payments which occurred between 1957 and 1960 did not impose too heavy a burden on Ceylon's economy owing to the availability of sizable reserves of external assets to finance the deficits. It became apparent by 1960, that the liberal trade policy followed up to then, could not be maintained. External assets which stood at Cey Rs 1,194 million at the end of 1956 had dwindled to Cey Rs 457 million by the end of 1960, largely as a result of import payments much in excess of export earnings.

Import and exchange controls were introduced, and these have continued up to now, with a brief period of liberalization for certain categories of imports under the Foreign Exchange Entitlement Certificate Scheme from May 1968 to August 1970.

The Committee will recall, that at the last consultation held in July 1969, full details of the FEEC's Scheme were submitted by the Ceylon delegation. One aspect of the FEEC's Scheme was to liberalize a considerable segment of the import trade by placing these imports under open general licence but subject to a premium rate of exchange.

The continued deterioration of the balance of payments of Ceylon, with no likelihood of any improvement in the near future, left no option to the Government but to suspend the open general licence scheme in May 1970 pending a review of the foreign exchange position. All imports were brought under individual import licences and quotas were issued in accordance with determined priorities. On 4 August 1970, the open general licence was abolished. Details of the FEEC's Scheme, as at present effective, are set out in Section II of document BOP/115. Even with the controls the high import demand has been maintained. Licences have been issued in 1970, for Cey Rs 1,438 million category A imports and Cey Rs 1,245 million category B imports (Section V of BOP/115).

In regard to complementary action in domestic financial policies, the measures taken in earlier years towards correcting the balance of payments were strengthened. Monetary policy in recent years has been dominated by the

exigences of the balance-of-payment's situation. Policy has been aimed at dampening the growth in monetary demand which had been occurring cumulatively over the past years as a result of large increase in the money supply caused by budget deficits; these in turn tended to exert pressures on the country's external reserves.

Monetary policy had, per force, to be restrictive. In order to mitigate the effects of a restrictive monetary policy on economic growth and on exports, it was desirable to permit a limited extent of credit expansion; differing shares of this expansion were allocated to different sectors on an order of priorities. Thus high reserve ratios continued to be effective and ceilings were maintained both on the domestic assets of the Central Bank and on commercial banks' credits to the private sector with a view to restraining the increase in money supply and in total domestic credit in particular. A selective approach was adopted in the matter of credit ceilings. The Central Bank continued to make refinance facilities available to growth sectors.

Changes in interest rates were also effected. The Bank Rate which has been raised on four occasions in recent years, was further increased from $5\frac{1}{2}$ to $6\frac{1}{2}$ per cent in January 1970. With the increase in Bank Rate, all the lending rates of commercial banks increased in January 1970.

In the last budget introduced in October 1970, primary emphasis has been placed on reducing, in the current fiscal year, the budget deficit requiring bank finance and a number of measures have been taken to mobilize additional resources for the budget. These include increases in interest rates on Government securities and savings deposits; increases in the rates of contributions to the Employers Provident Fund; and a compulsory savings scheme.

An unique and novel measure in Ceylon's monetary history was introduced in the last budget; currency notes of Cey Rs 100 and Cey Rs 50, the largest denominations in circulation were demonetized. The objective of the measure was to smoke out currency hoarders and tax evaders. As a consequence of this anti-hoarding measure a minimum of Cey Rs 100 million, as additional taxes, is expected during the current fiscal year ending 30 September 1971.

As indicated in Spec(71)36 the Government has also tried to give due weight to balance-of-payments considerations in the formulation of the country's industrial policy as well as to emphasize its programme of import substitution in agriculture.

The fundamental imbalance in Ceylon's balance of payments is basically the result of expenditure outstripping available resources. The obvious solution is to reduce expenditure and such reduction should fall on current consumption rather than on investment. While one recognizes the problem and the solution to it, it is not always easy to introduce measures designed to correct the problem. Ceylon's heavy dependence on three products for its foreign exchange earnings, and the continuing deterioration in prices for these products, accompanied by increasing prices for essential imports makes it extremely difficult to implement effective monetary and fiscal policies. A concerted national effort maintained over a long period is necessary to place the balance of payments on a sound footing.