

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/33) including the Ceylon Government Gazette which contains notifications of the import control system; (b) a background document provided by the International Monetary Fund. The consultation was completed on 22 May 1964. The present report summarizes the main points discussed during the consultations.

Consultations with the International Monetary Fund

2. 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 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:

"The International Monetary Fund has transmitted to the CONTRACTING PARTIES a background paper dated April 27, 1964.

"With respect to Part I of the Plan for Consultations, relating to balance of payments position and prospects, and with respect to Part III, relating to system and methods of the restrictions, the general level of the various restrictive and temporary tariff measures being applied does not go beyond the extent necessary at the present time to stop a serious decline in Ceylon's monetary reserves.

"With respect to Part II of the Plan for Consultations, relating to alternative measures to restore equilibrium, pending the conclusion of its current consultation with Ceylon under Article XIV of the Fund Agreement, the Fund has no comments on alternative measures".

Opening statement of the representative of Ceylon

3. The representative of Ceylon, whose full statement is appended in the Annex, described recent developments in Ceylon's economy and trade. Briefly, 1963 had been a particularly difficult year; Ceylon had already experienced imbalance in its external accounts in prior years which had led to a decline in reserves and the need to impose restrictions to safeguard external assets. Worsening terms of trade had contributed to the deterioration of Ceylon's balance-of-payments position ever since 1955/56, but this movement culminated in 1963 in a 10 per cent decline in the one year. This decline was due entirely to the rise in import prices not accompanied by an increase in export prices. Important import price increases took place in sugar and other goods which Ceylon must import, while prices of major primary exports - tea, rubber and coconuts - did not rise. The essential imports could not easily be reduced in volume, and other imports had already been cut sharply in prior years. Thus, on balance, total payments for imports continued to exceed receipts from exports and other sources, causing a sizeable deficit in the balance of payments on current account and reducing Ceylon's reserves at the same time that Ceylon increased its foreign commitments.
4. Internally, the higher prices of imported food led directly to a frustrating of the Government's effort to combat a tendency toward inflation to which heavy budget deficits had been contributing for some years. Imported food is all sold under subsidy and it had been planned to cut the internal deficit to about one-fourth through reduction of these subsidies in the fiscal year 1963/64. With higher world prices, however, adherence to this plan would have meant a too sharp increase in food prices. Hence, though the budget for the fiscal year 1963/64 (Oct.-Sept.) envisaged a much smaller cash deficit, the deficit was now expected to be only slightly less than in the year before. That the deficit would not be larger was thanks in part to other economy measures which are meeting with somewhat more success despite great pressures to increase expenditure on development; vigorous efforts to raise additional revenue by direct and indirect taxation are important in this connexion.
5. Production in certain export sectors had been fostered with some success in tea and coconuts, but rubber production would not increase for another three or four years when new trees would begin to yield. Overall, Ceylon's exports increased at the rate of 2.9 per cent per year in the last decade, but the import purchasing power of these exports increased by only 1.1 per cent per year. Efforts to grow more of Ceylon's rice requirements continued, with the result that despite an increase in population over recent years imports of rice had remained constant; yields per acre are beginning to rise but much remains to be done. Industrial development, especially in Ceylon's light

consumer industries, to some extent a by-product of import restrictions, had been an important feature both psychologically and from an economic standpoint, and Ceylon realized that it was now time to begin to select for development those industries which could be viable in the long run.

6. In monetary policy, Ceylon's objective has been to counteract the effects on prices of an expansion in the supply of money and of restriction of imports. Heretofore, stocks have lessened these pressures, so that Ceylon had not experienced any real inflation, but it was expected that this problem will become more significant. It will be extremely difficult to contain the pressures along with an adequate development programme if the external background continues to be unfavourable.

Balance-of-payments position and prospects

7. The Committee thanked the representative of Ceylon for his detailed statement and expressed appreciation and understanding of the difficulties with which Ceylon was currently faced, including the recent deterioration of the country's terms of trade. 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. Members of the Committee noted that the preliminary figures for the balance of payments of Ceylon for 1963 indicated a decrease in the value of exports to Rs.1,725 million in comparison to Rs.1,763 million in 1962. Imports fell from a value of Rs.1,906 million in 1962 to Rs.1,854 million in 1963. Taking account of an increased deficit in invisibles the total deficit on current account amounted to Rs.146 million, about the same as in 1962. The representative of Ceylon explained that the deficit on services had increased considerably in the last year, totalling Rs.22 million in 1963 as compared to Rs.8 million in 1962, and this increased service deficit was attributed to reduced earnings from port services and bunkering during strikes in the port of Colombo. In respect to donations, he stated that in 1963 the surplus had decreased to Rs.5 million as compared to Rs.7 million in 1962. In reply to a question from the Chairman as to whether the trends in 1963 continued in the first quarter of this year, the representative of Ceylon mentioned that the balance-of-payments position continued to worsen. However, a break was noticeable in lower sugar prices and they hoped that the situation might further improve in the remaining three quarters of the calendar year. The Committee was informed that the Government was taking measures to develop tourism in Ceylon and in recent years receipts from tourism had increased somewhat. In reply to a question the representative of Ceylon informed the Committee that the net outflow of private capital amounted to Rs.7 million in 1963, and the net inflow of long-term official capital Rs.75 million. This last figure indicates the extent of the increased reliance on long-term capital from abroad.

9. The representative of Ceylon noted that although the IMF had adopted a new facility for drawings by members suffering from temporary export shortfalls, this facility was not available to meet the effects of rising import prices such as had recently been faced by Ceylon.

10. In response to a question concerning the tax treatment of foreign remittances, the Committee was informed that a tax of 10 to 20 per cent had been imposed on foreign payments in respect of holiday travel, commissions and advertising. The representative of Ceylon explained that the tax was not applied to other remittances, e.g. profits and dividends.

Alternative measures to restore equilibrium

11. Members of the Committee expressed appreciation for the statement made by the representative of Ceylon that his Government was aware of the tendency toward a rise in prices. They noted, also, that the expected cash deficit of some Rs.200 million in the expenditures for 1963/64 was slightly smaller than in earlier years and that despite the pressure to increase current expenditure the deficit had not increased over those of previous years, partly because of the Government's vigorous efforts to raise revenue. The Committee expressed understanding of the particular difficulties with which Ceylon was faced in implementing measures for fiscal and monetary restraint as long as there continued to be under-employment of resources. The Committee noted with satisfaction the measures Ceylon was undertaking to curb domestic demand and expressed the hope that in view of the inevitable impetus which restrictions had given to the development of industries, further efforts would be made towards rationalization of these industries from the long-term aspect.

12. The representative of Ceylon, in his statement, gave a full account of his Government's fiscal and monetary policy as well as a report on production plans. The Ceylonese Government was much aware of the problem of rationalization of the new industries and significant efforts were being made to promote viable industries.

13. In reply to a question on the capacity of the recently installed sugar mills to help meet current domestic requirements, he explained that as the installation of the factories had been completed only recently, they had not come into full production. There were also serious agricultural problems to be resolved in increasing the supply of sugar-cane production, for example water supply, changing rural habits from the farming of traditional products to sugar cultivation and labour supply. Thus, so far they were substantially dependent on imports.

14. In regard to a question about the replanting of old rubber trees with new high yielding varieties, the representative of Ceylon explained that a modest replanting scheme had been undertaken. This scheme was not as extensive as similar replanting schemes adopted in other countries, e.g. Malaya, since the Government of Ceylon was not convinced that the sale of substantially larger quantities of rubber at lower prices would necessarily yield larger total foreign exchange earnings from that product in the context of the relationship between the price of the natural and synthetic products.

System and method of the restriction

15. The Committee recognized the difficulties confronting Ceylon in protecting its foreign exchange reserves in the face of adverse factors affecting its terms of trade and in implementing its development programme.

16. In reply to a question about the use of import restrictions simultaneously with tariff increases, the Ceylon delegate explained that tariff measures continued to be used in spite of their failure as a means of restraining imports, in order to siphon off some of the excess domestic demand and windfall profits.

17. Members of the Committee inquired about the decline in imports under Open General Licence and under special quota. The representative of Ceylon replied that it had been necessary to shorten the list of items under Open General Licence and that the policy on special quotas had not been implemented; it was the intention of the Government to permit import of non-essential items in small quantities, provided the balance-of-payments position improved. Lists of special quota items would be published when decisions had been reached.

18. In response to a question concerning the definition of the term "Ceylonized areas", it was explained that these areas comprised countries with which Ceylon's trade came to a standstill during and immediately after the war and that imports from these areas were reserved for Ceylonese traders only.

19. In reply to a question regarding bilateral arrangements, the representative of Ceylon explained that his Government did not believe in bilateral arrangements as such, but in order to promote new trade with centrally-planned economies and certain State-trading countries, they were obliged to support bilateral arrangements. The centrally-planned countries adopted the system of bilateral arrangements for the conduct of their trade with other countries, and therefore Ceylon could not abandon the use of bilateral arrangements unless the system was changed by the industrialized countries having centrally-planned economies, and by other State-trading countries with whom Ceylon had bilateral arrangements.

20. Members of the Committee enquired if Ceylon was considering the establishment of a State-trading corporation. It was indicated by the representative of Ceylon that his Government did not foresee any definite plan at present although the matter had been under consideration for some time.

Effects of restriction

21. The Committee expressed its appreciation of the efforts of Ceylon to increase productivity of its domestic industries but nevertheless indicated its hope that further efforts to rationalize industry would be pressed forward. The representative of Ceylon indicated that his Government kept under review existing industries and in regard to new industries there were procedures for screening industries for essentiality of the proposed product, for their ability to produce on a competitive basis and for their export potential.

General

22. The Committee thanked the representatives of Ceylon for the frank and co-operative manner in which they had engaged in the consultation and expressed understanding of the problems with which Ceylon was confronted. The Committee noted the statement made by the representative of the Fund that "the general level of the various restrictive and temporary tariff measures being applied does not go beyond the extent necessary at the present time to stop a serious decline in Ceylon's monetary reserves". The Committee noted the various fiscal measures taken by the Ceylonese Government to curb the large import demand and raise revenue.

23. 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 during the consultation to the attention of his Government which would give them careful consideration.

ANNEXOpening Statement by the Representative of Ceylon

Mr. Chairman, I believe it is the purpose of this statement to give those assembled here a general picture, or an outline, of developments in Ceylon particularly in respect of 1963. I expect that you have received a copy of the background material submitted by the Fund and also a copy of the Annual Report of the Central Bank which was published at the beginning of April. These two documents provide the factual material needed for a more detailed appraisal of our situation.

Speaking generally, I think it would be true to say that 1963 turned out to be, very clearly, a difficult year for Ceylon. Even prior to that year, Ceylon had experienced a period of imbalance in her external accounts which led to a decline in external reserves and the need to impose restrictions on imports so as to safeguard these reserves. Since about 1955 or 1956, Ceylon's terms of trade have been tending, by and large, in a downward direction. But 1963 saw a particularly sharp deterioration in Ceylon's terms of trade. Within a single year we experienced a decline in the terms of trade of almost 10 per cent. This deterioration in the terms of trade was not, however, the result of a decline in the average level of Ceylon's export prices. On the contrary, the overall index of export prices remained more or less constant in comparison to the preceding year. The decline in the terms of trade was due entirely to a rise in the index of import prices. This was in a sense a rather paradoxical situation since for most primary producing countries 1963 turned out to be a relatively good year, vis-à-vis the terms of trade and the balance of payments. But Ceylon was one of those exceptional cases, where 1963 turned out to be singularly unfavourable.

The reason for this is, of course, not far to seek - Ceylon is a country which imports a substantial volume of primary products, particularly foodstuffs like rice, flour and sugar; and the firming up of primary product prices in respect of these commodities naturally affected the price index of Ceylon's imports. Ceylon's exports on the other hand - tea, rubber and coconut - did not share in the general improvement in primary product prices that took place throughout the world. The prices of these commodities, as I said before, remained on average more or less static. A major element in the increase in import prices as far as Ceylon is concerned was the very sharp rise in the price of sugar. Despite recent efforts by the Government of Ceylon to initiate the production of sugar in Ceylon, I think it is true to say that we are still dependent for a very substantial proportion of our requirements of sugar on imports from abroad. The very sharp increase in sugar prices in the course of last year did have a marked impact on our total import bill and contributed towards the overall deterioration in the import price index.

Since the increase in import prices affected items of essential foodstuffs which figure prominently in the consumer budget, it was not possible to cushion the impact of this increase in prices on the balance of payments through a reduction in the volume of imports of these commodities. Ceylon had to maintain the volume of imports of sugar and rice and flour - items which are imported by Government and, in the case of rice, distributed on the ration. It was not possible, in other words, for Ceylon to react to the increase in import prices by a very sharp reduction in the volume of imports. I say this notwithstanding the fact that economies were made to as large an extent as possible in respect of imports other than foodstuffs. If one examines the overall index of volumes one does find that this index did decline quite significantly during the course of the year. But since restrictions on imports had been introduced in the years prior to 1963 and a degree of curtailment had already been initiated, the margin for a further degree of restriction was naturally somewhat limited. Hence on balance we had little alternative but to face a situation where our total outlays on imports continued to be large and in excess of our total receipts from exports and other sources.

Thus in 1963, Ceylon faced a continued deficit in her balance of payments on current account, and this deficit was reflected, in part, in a further decline in external reserves. I should add here that in 1963, as in 1962, Ceylon was able to finance the deficit on current account through a resort to increased external liabilities as well as through a running down of external assets. In 1962, however, a significant proportion of the total deficit on current account was financed through an increase in short-term external liabilities. One of the interesting features of the financing of the deficit in 1963, on the other hand, was the somewhat larger reliance on an increase in long-term external liabilities. In 1963 Ceylon's long-term external liabilities, in other words the receipt of long-term aid and official capital inflows, contributed significantly to the financing of the overall deficit.

It would be appreciated that the situation which necessitated the maintenance of restrictions on imports during 1963, and indeed their intensification, made it difficult for Ceylon to provide any relief in respect of the internal supply situation. As I indicated earlier, restrictions on imports began to be introduced as far back as 1961 and 1962. It was our hope that if the external situation improved we could introduce a degree of relaxation in respect of imports so as to augment the supply of goods in the domestic market and to relieve the pressure of prices. That adverse turn in the terms of trade completely thwarted our expectations in this respect and compelled us to maintain, and in some cases to intensify the restrictions that had been imposed earlier.

Now the situation brought about by the rise in import prices reacted on the economy of Ceylon in another important way. As mentioned earlier, the increase in prices had its main impact on food items. Rice, flour and sugar are items

which are imported on Government account. Rice is sold at a subsidized price and on a ration. Flour and sugar are not sold at subsidized prices, but are distributed through governmental machinery. Now, given the increase in the external prices of these foodstuffs, and given the fact that the domestic selling price was maintained at previous levels - and there were, I need hardly say, very grave political problems in the way of immediately increasing the domestic selling prices in response to the increase in external prices - given these factors, the main impact of the rise in external prices was not only the deficit in the external payments account, but also an expansion or enlargement of the Government's fiscal deficit. In other words, the overall budget deficit of the Government did increase substantially relative to expectations largely on account of the swelling of the food subsidy bill.

I might recall here that for the last four years or so Ceylon has incurred fairly large deficits in the overall Government budget. However, the budgets for the financial years 1962/63 and 1963/64 did attempt, short of reducing the food subsidies, to scale down these overall deficits to as large an extent as possible. In fact, the budget for 1963/64, as presented, anticipated a sizeable reduction in the overall expansionary gap from something like Rs.200,000,000 in previous years to about Rs.54,000,000. But in view of the rise in import prices, and the consequent increase in the food subsidy bill, as well as other factors, the overall deficit in the budget could not attain the reduced dimensions that were anticipated. In this connexion, however, I would like to draw your attention to the fact that although the budgetary deficits have been large, they have been effectively contained at a certain level for the last three or four years. In other words, despite the great pressure to increase expenditures, current expenditures and development expenditures, we have not witnessed a continued acceleration in the scale of the budgetary deficits. On the contrary, we have maintained a plateau - a gradually declining one in fact - in respect of the scale of the Government's budget deficits.

In this connexion, the effect of the Government's revenue efforts needs to be noted. The containment of the budgetary deficits was made possible because of vigorous efforts to raise additional revenues. Taxation has been increased in several directions. Relatively high rates of direct taxation have been imposed; and we have also introduced several new taxes of one kind or another. In the last budget, a turnover tax, something which is the equivalent of a sales tax, was introduced. This is part of an attempt to broaden the base or the incidence of taxation in Ceylon so that a larger part of the community would contribute to the revenue system. In addition to taxation we have stepped up our efforts to mobilize domestic savings. In this respect one of the important and significant developments of recent years has been the introduction and implementation of a compulsory provident fund scheme to which virtually the whole of the organized wage earning sector now contributes, and which provides something like Rs.70 or 80 million by way of subscriptions to government loans.

I must emphasize that the difficulties that I have mentioned regarding the rise in import prices are of particular relevance to the current financial year 1963/64. As earlier indicated, the expansionary deficit was initially estimated at Rs.50 million. But now, on account of the rise in external food prices, this figure needs to be revised. Our estimate, at the time we made it three to four months ago was that the increase in the external price of food would itself enlarge the food import bill and the Government budget deficit by a further Rs.167 million. There would, of course, be some offsetting factors which would tend to act in the opposite direction and reduce the net expansionary deficit in the budget to a figure somewhat below the gross figure. We anticipate somewhat greater receipts from external aid for example. But there can be little doubt that in the final result the deficit would be larger than expected.

Well, this is the background in respect of external factors and their impact on the fiscal situation in Ceylon. Internally, there are two developments which I would like to mention - the first concerning production and the second the internal price level. In the field of domestic production, we have in recent years witnessed significant increases in output in certain sectors of the economy. There are three sectors in particular to which I would like to draw your attention. In the export sector we have seen a steady and welcome increase in the production of tea which is one of our major export crops. The output of tea has increased by between 3 and 4 per cent a year on average over the last ten years. This increase in volume has not, however, been accompanied by a proportionate increase in our total earnings from tea, because of a downward trend in regard to tea prices. But the fact that we have sustained this increase in output year after year has been a source of strength and a source of relief to our external account and to the economy as a whole. In the case of rubber, which is another of our export crops, we have not witnessed a comparable increase in output. This has largely been due to the fact that there has been some loss of output due to the uprooting of old trees as part of the programme of replanting. But we may expect that over the next three or four years, the areas which were replanted around 1953, 1954 and 1955 would begin to come into bearing and this should serve to stimulate total output and set it on an upward course. The production of coconuts, yet another export item, is very susceptible to weather conditions. Years of good rainfall are succeeded by an increase in output whilst years of bad rainfall are followed by a contraction. But here again there has been a trend towards an increase in fertilizer application and towards the adoption of other measures of rehabilitation, and I would anticipate that the long-term trend is in the direction of an increase in output. Thus in regard to the export sector, our experience has been a relatively favourable one in so far as the country's productive efforts are concerned. But these productive efforts have been negated or offset to some extent by the deterioration in prices. In the last report of the Central Bank of Ceylon, it was estimated that whilst on average, over the last ten years, the volume of Ceylon's exports

grew at a rate of about 2.1 per cent per year, the purchasing power of these exports, i.e., export values deflated by the import price index, increased at a rate of only 0.9 per cent a year. In other words, we have not benefited to the full by our efforts to increase production in the export sector because these efforts have in part been negated by unfavourable developments in respect of external prices.

In the domestic agricultural sector, Ceylon has for many years, been making an effort to expand the total production of rice, both by encouraging the introduction of better methods into areas already cultivated and by extending the area of cultivation by new schemes of irrigation and development and colonization. For some time there was no obvious evidence of an upward trend in regard to yields per acre, but now I think that we are beginning to see signs of an increase in productivity. We have succeeded in raising the total output of rice over the last five or six years and there appears to be a clear indication that average yields per acre are taking an upward course. The statistics of rice production are, of course, not as precise as we would like them to be. We undertake sample surveys to estimate total production and these are liable to a certain degree of error; but these results certainly suggest that total rice production is increasing quite significantly. This is confirmed by the fact that despite the very rapid increase in population total imports of rice have not increased very much. However, yields per acre in rice production are still low in Ceylon compared to what they might be, and compared to what they are in countries like Japan, and it is certain therefore that there is still great scope for further improvement in this direction. But I feel that we have made a useful beginning and this has been the result of very intensive efforts in the way of extension work, in the way of better systems of credit and marketing, of tenural reforms and so on.

The third sector of production which I would like to comment upon and which is of considerable significance to us is that of industry. One of the notable features of Ceylon's experience in the past two years or so has been the beginning of a process of industrialization. A number of industries are now developing in Ceylon - many of them light industries, consumer industries - which did not exist before. Admittedly many of them have developed as a by-product of import restrictions, but all the same this has been a very encouraging feature which has had a psychological as well as an economic impact on Ceylon. It has certainly given rise to new hopes and to a new vision as regards the structural changes possible in the Ceylon economy. Since the early fifties, Ceylon has been attempting to encourage the development of industry by such indirect measures as tax incentive legislation, policy declarations concerning local and foreign capital, liberal exchange policies and so forth but the results were not at all impressive. They were in fact very poor. But despite the change in the overall economic situation and tightened exchange restrictions,

the mere fact of the creation of an assured market through import controls seemed to have provided a stimulus to industrial development. I think many people in Ceylon have drawn a rather interesting moral from this experience as regards the whole question of policies for industrial development. But there is now a need for an effort to try and rationalize these industries by a selective policy so as to ensure they will prove to be viable in the long run.

The final comment I wish to make concerns internal prices. Despite the increase in domestic production, the pressure of excess demand related to budgetary deficits has imposed strains on prices. For many years, I would say in fact until last year, this pressure was not transmitted into an actual increase in prices because stocks of supplies previously imported were available to meet the increase in demand. But now, with the gradual exhaustion of these stocks, and the continuance of a degree of monetary and fiscal expansion, in the background of restrictions on imports, there has been an undoubted pressure on prices. The increase in prices has not as yet reached sharp proportions. I do not think that Ceylon has witnessed anything like the increase in prices that was witnessed by some other countries undergoing a process of inflation. But we are aware of the tendency of prices to move upwards and the need to keep it within limits. We have not yet had any manifestations of a secondary round of wage increases or anything like a cumulative spiral effect.

In conclusion, I must point out that had the external situation not turned unfavourable our efforts to curtail the price increase, to curb the inflationary pressure, would have been more successful. I think it would be true to say that the ability of Ceylon to maintain a development programme which is within the bounds of political reality and to sustain a process of expansion would be gravely limited if the external background continues to be unfavourable. It is a difficult task to postulate and implement sound, effective, and acceptable monetary and fiscal policies against a background of a continuing deterioration in external price relations. It would be correct to say that success in Ceylon's internal monetary efforts depends very much on the extent to which these efforts are strengthened and reinforced by relatively favourable external conditions. I think Ceylon has every cause to lament the turn of events on the external front and we do feel that we ought to bring this factor to the notice of international bodies such as yours.