GENERAL AGREEMENT

ON TARIFFS AND TRADE

RESTRICTED
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Limited Distribution

(94-1481)

Committee on Balance-of-Payments Restrictions

1994 CONSULTATION WITH SRI LANKA (SIMPLIFIED PROCEDURES)

Background Paper by the Secretariat

1. This paper has been prepared in accordance with paragraph 7 of the Declaration on Trade Measures Taken for Balance-of-Payments Purposes (BISD 26/205) to assist the Committee on Balance-of-Payments Restrictions in taking the decision referred to in paragraph 8 of the Declaration.

I. Sri Lanka's previous consultations

2. The last full consultation with Sri Lanka took place on 22 June 1971. At that consultation the Committee recognized that the then balance-of-payments difficulties of Sri Lanka warranted the use of quantitative restrictions on imports. The Committee urged Sri Lanka 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 (BOP/R/58, paragraph 27).

3. The last full consultation was followed by consultations under simplified procedures in 1973, 1975, 1977, 1977, 1979, 1981, 1983, 1985, 1987, 1989 and 1992 (BOP/R/198). At the last simplified consultation, the Committee took note that Sri Lanka would notify as soon as possible the list of remaining import restrictions maintained for balance-of-payments purposes.

II. Sri Lanka's trade policy and recent changes

(a) Tariffs and other charges on imports

4. The 1991 Budget introduced a four-band import tariff structure intended to reduce effective rates of protection. From November 1991 most import tariffs were grouped into rates of 10,20,35 and 50 per cent. As part of the liberalization package, the maximum tariff was lowered to 50 per cent with the exception of motor vehicles, liquor and cigarettes. In November 1993, the maximum duty rate was reduced from 50 to 45 per cent and is to be lowered further to 35 per cent in the 1995 budget resulting in a three-band structure. A number of items continue to face customs duties outside the four-band system. Some products, including pharmaceuticals and fertilizers, are zero rated. Automobiles, most textiles, garments and tobacco products carry customs duties of 50 per cent or more.

5. In the Uruguay Round market access negotiations, Sri Lanka has reduced tariffs by an average of 23 per cent on agricultural products and in industry, has increased its bindings from a pre-Uruguay Round level of 4 per cent of tariff lines (7 per cent of imports) to 8 per cent of tariff lines (11 per cent of imports); the average tariff on industrial products has been lowered by 2 per cent to 28.1 per cent.

6. Recent trade reform has included the conversion of all but a few of roughly 1000 specific duties (or reference prices) to an ad valorem rate of 50 per cent; specific duties on textiles were converted to 100 per cent ad valorem rate, which were reduced to 50 per cent in November 1993. Remaining specific duties will be converted into ad valorem rates by 1995.

7. In August 1992, the requirement for 100 per cent cash margin to be deposited against letters of credit for imports of luxury goods was abolished.

8. In case of goods in the highest tariff band, a special surcharge is imposed, the Export Development Board (EDB) cess. The EDB cess is assessed at 10 per cent of the import duty.

9. Discretionary duty and tax concessions remain available. Authority to grant duty concessions has been consolidated in the Treasury and their use is to be limited. In reforms undertaken in late 1993, some duty exemptions were eliminated.

(b) Licensing

10. In June 1993, a number of export and import licensing requirements were removed. However, licensing restrictions were imposed on imports of certain types of diesel engines and motor cars over three years old. In case of exports, licensing requirements are limited for 11 items, mainly for environmental reasons. The products which are still subject to import licensing are listed in Sri Lanka's statement for the consultation (BOP/320). According to the authorities of Sri Lanka, most of the import licensing requirements are maintained for national security, public health, public morals and environmental considerations. In lack of available precise information, the Secretariat was not in a position to determine the products whose importation is subject to restrictions for balance-of-payments reasons.

11. Certain state trading monopolies have been opened to the private sector; in December 1993, the private sector was permitted to import wheat and wheat flour.

(d) Foreign exchange policy

12 The requirement to surrender foreign exchange proceeds from export earnings was lifted in March 1993, completing the removal of restrictions on current transactions and Sri Lanka has accepted the Article VIII obligations of the IMF.

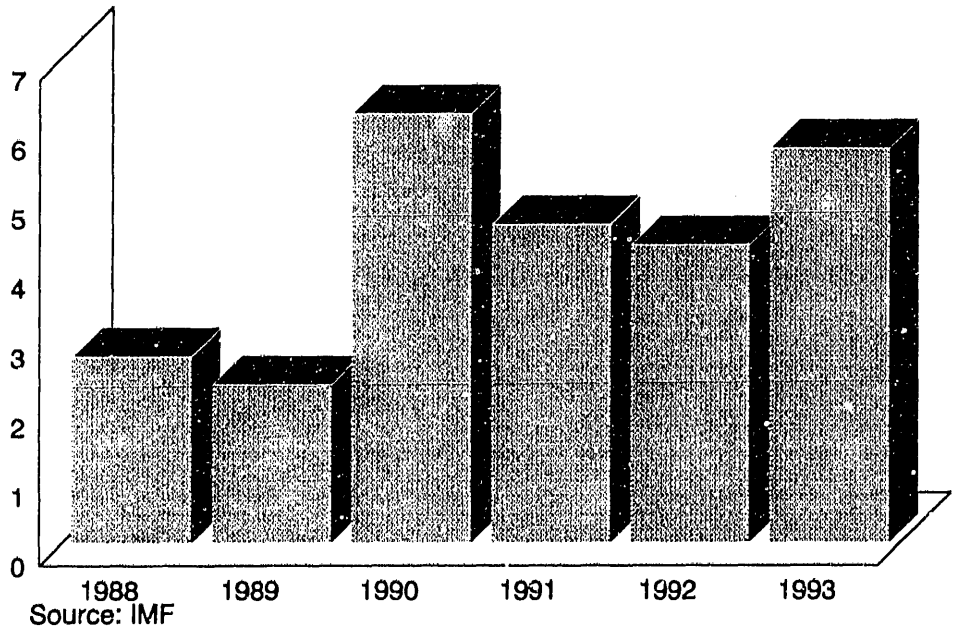
III. Economic and Trade Developments

Economic Growth

13. Real GDP growth averaged 4 per cent over the 1988-1992 period, with particularly robust growth being recorded in 1990 (6.2 per cent) in response to a high growth rate in the agricultural sector (Chart 1).

Chart 1 - Sri Lanka - Real GDP Growth, 1988-93

(Annual percentage change)



Source: IMF

14. The pace of economic growth was adversely affected 1992 owing to a severe drought, however, the growth rate in that year (4.3 per cent) was about the same as the average growth rate over the 1988-92 period (4 per cent). Sectoral shares of GDP in 1993: 21 per cent agriculture; 19 per cent manufacturing; 2.5 per cent in mining; 7 per cent construction; and 50 per cent services and other. A real GDP growth rate has been provisionally estimated at 6.9 per cent for 1993, led by 10.5 per cent growth in the manufacturing sector and a solid recovery by the agricultural sector from the 1992 drought (5 per cent growth).

Inflation

15. Inflation averaged 14 per cent between 1990 and 1993. The rate of inflation, as measured by the consumer price index, reached 21.5 per cent in 1990 in response to the government's policy of cutting subsidies, widening budget deficits and rapid monetary growth. The government attenuated inflationary pressures (inflation rate declined to 11.4 per cent in 1992 before edging up to 11.7 per cent in 1993) primarily through higher interest rates. However, the authorities have been unable to bring inflation down to single digits owing to their limited success in containing expansion in the face of continued large inflows of foreign capital and the continued high fiscal deficits.

Unemployment

16. The unemployment rate was estimated to be 16.6 per cent in 1992. Double-digit unemployment persists owing to pervasive labour regulation and other market rigidities.

Public Finance

17. Government revenues grew by 14.1 per cent per annum, compared with a 12.4 per cent per annum increase in government expenditure between 1990 and 1993, thus dampening the growth of the overall budget deficit. The overall budget deficit fell from 9.9 per cent of GDP in 1990 to 7.4 per cent in 1992 before rising slightly to 8.1 per cent in 1993. The reduction was effected not by increasing revenue, but by restraining real growth in expenditure. In recent years, defence has accounted for a significant proportion of spending and was also responsible for expenditure overruns in both 1986 and 1987. Major capital spending projects have included the Accelerated *Mahaweli* Project, rehabilitation of the plantation sector, housing and urban development. To finance the increased deficit, the government was forced to resort to domestic nonbank financing, primarily through the issuance of treasury bills. Since 1988, some improvements have been made to government finances, in line with agreements under Sri Lanka's Fund programme. Revenue collection has improved but defence spending is still a strain on the budget.

18. Taxes on goods and services provided 48 per cent of the government's revenue, taxes on international trade 22 per cent, nontax revenue 11 per cent, stamp duty & taxes on property 3.3 per cent, and tax on Central Bank holdings of treasury bills 1 per cent. Corporate and private taxation (income tax) is a poor source of revenue, accounting for only 13.7 per cent of receipts in 1993. Tax concessions for activities the government wishes to encourage are widespread, but they add to the burden on the tax paying sector. A 1 per cent defence levy, introduced in 1992, and later raised to 3.5 per cent, applies to all imports, manufactures, banking, finance and insurance transactions. Social spending accounts for about one-third of current expenditure, and interest payments on outstanding debt for more than 30 per cent. The share of defence spending has risen in recent years and accounted for 14.4 per cent of current spending in 1992. A figure of 12.6 per cent is estimated for 1993. The central government's domestic debt, on the other hand, declined from 47 per cent of GDP in 1989 to 43 per cent in 1993.

Trade

(a) Composition and Direction of Merchandise Trade

19. Sri Lanka's export composition continued to evolve over the 1988-93 period. The share of industrial products in total exports increased from 50.6 per cent in 1989 to 71 per cent in 1993, while agricultural exports (notably tea, rubber and coconut) continued their downward descent from 39.3 per cent to 23.3 per cent (Table 1). The value of industrial product exports recorded an increase of 18 per cent in 1993; of particular significance was the performance of the textile sector, which registered a 16 per cent increase in export earnings. Imports of consumer goods rose by 5.2 per cent and intermediate goods by 15.1 per cent. Data on imports reported in Table 2 indicate that manufactures accounted for at least 70 per cent of total merchandise imports in 1993, of which machinery, transport equipment and building materials were the most important components, accounting for nearly 70 per cent of total manufactured imports. The United States remained the major export market, followed closely by the European Union; while imports entered mainly from the Asian countries, the European Union, Japan, and the Middles East.

Table 1
Sri Lankan Merchandise Exports by Product Group, 1988-93
(Million SDRs and percentage share)

Description	1989	1990	1991	1992	1993
Total exports (SDRs million)	1217.0	1456.1	1490.6	1747.6	2026.7
Agricultural products	39.3	36.4	31.4	24.4	23.3
Tea	24.3	25.0	21.2	13.8	14.2
Rubber	5.5	3.9	3.1	2.7	2.4
Coconut	5.2	3.5	3.1	3.4	2.3
Other agricultural products	4.3	4.0	4.0	4.5	4.3
Industrial products	50.6	51.1	59.0	69.9	71.0
Garments & textiles	31.4	32.8	40.5	48.8	48.6
Gems	9.7	8.6	6.3	6.7	7.2
Other industrial products	9.5	11.0	13.5	14.6	15.2
Petroleum products	4.0	5.2	4.0	2.6	2.85
Miscellaneous exports	6.1	7.5	5.6	3.0	2.8

Source: IMF.

Current Account

20. Gross domestic investment as a per cent of GDP picked up in 1990 after declining steadily from 33.8 per cent in 1980 to 21.7 per cent in 1989. It reached nearly 26 per cent of GDP in 1993 (see Table 3). Gross savings on the other hand, remained on an improving trend, increasing from 11.2 per cent of GDP in 1980 to 14.3 per cent in 1990 and 16.7 per cent in 1993. Gross domestic savings have lagged behind gross domestic investment since the 1980s, and the country has posted current account deficit. As a share of GDP, the current account deficit averaged 6.1 per cent between 1990 and 1993. It declined from 7.5 per cent of GDP in 1991 to 5.3 per cent in 1993, reflecting faster pace of export growth relative to the growth of imports of both merchandise and services (see chart 2).

21. Growth in industrial exports has contributed to a faster overall export growth, relative to imports, in recent years; but since imports were growing from a higher base there has been no real narrowing of the trade deficit. As the value of merchandise imports rose from 1.7 billion SDRs in 1989 to 2.8 billion in 1993, the current account deficit peaked in 1989 at SDR243 million but declined sharply to SDR192 million in 1990. By 1993, the current account deficit was SDR276 million, however, the current account deficit as a percentage of GDP was about the same as for 1990 (5.3 per cent versus 5.4 per cent).

Table 2
Sri Lankan Merchandise Imports by Product Group, 1989-93
(Million SDRs and percentage share)

Description	1989	1990	1991	1992	1993
Total imports (SDRs million)	1737.0	1973.9	2216.3	2469.0	2818.2
Consumer goods	32.3	30.0	28.4	27.9	25.7
Rice	4.2	1.6	1.3	1.9	1.0
Wheat	6.2	3.5	2.6	3.0	3.2
Sugar	5.4	4.8	4.1	3.2	3.1
Other food	6.7	8.1	8.0	6.9	6.9
Other consumer goods	9.7	11.9	12.4	12.8	11.5
Intermediate goods	50.3	48.1	47.6	47.3	47.7
Petroleum	10.5	13.4	10.3	9.1	7.7
Fertilizer	2.2	2.7	1.9	1.5	1.5
Textiles	12.4	12.5	16.4	17.6	19.6
Other intermediate goods	25.1	19.4	19.0	19.0	18.8
Investment goods	15.0	21.8	23.7	24.7	26.6
Unclassified	2.5	0.1	0.[illegible]	0.1	...

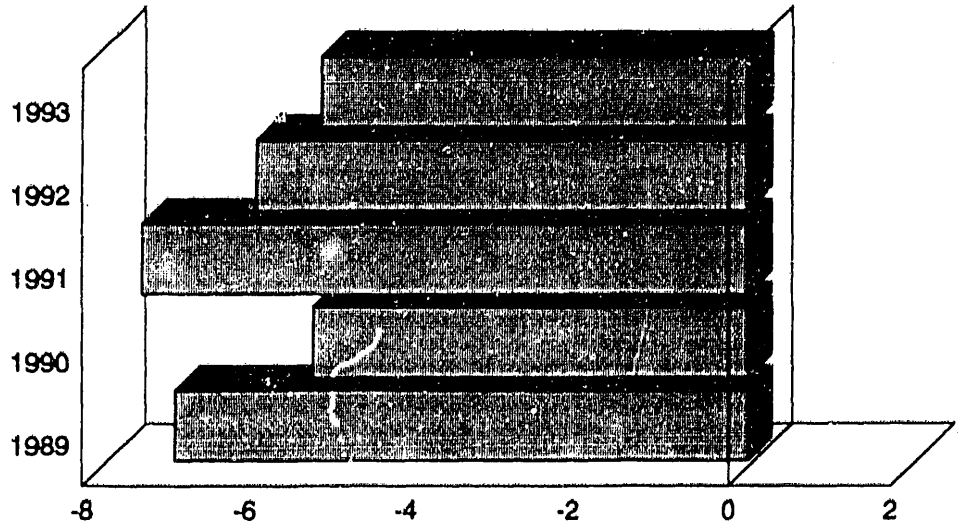
Source: IMF

Table 3
Sri Lanka: Gross domestic investment, Savings, and Current account balance 1980, 1989-1993
(Percent of GDP)

	1980	1989	1990	1991	1992	1993
Gross domestic investment	33.8	21.7	22.2	22.9	23.7	25.9
Domestic savings	11.2	12.2	14.3	12.8	14.7	16.7
Current account balance	-16.3	-7.1	-5.4	-7.5	-6.1	-5.3

Source: IMF

Chart 2: Sri Lanka - Current account balance as a percentage of GDP



Source: IMF

Balance of Payments

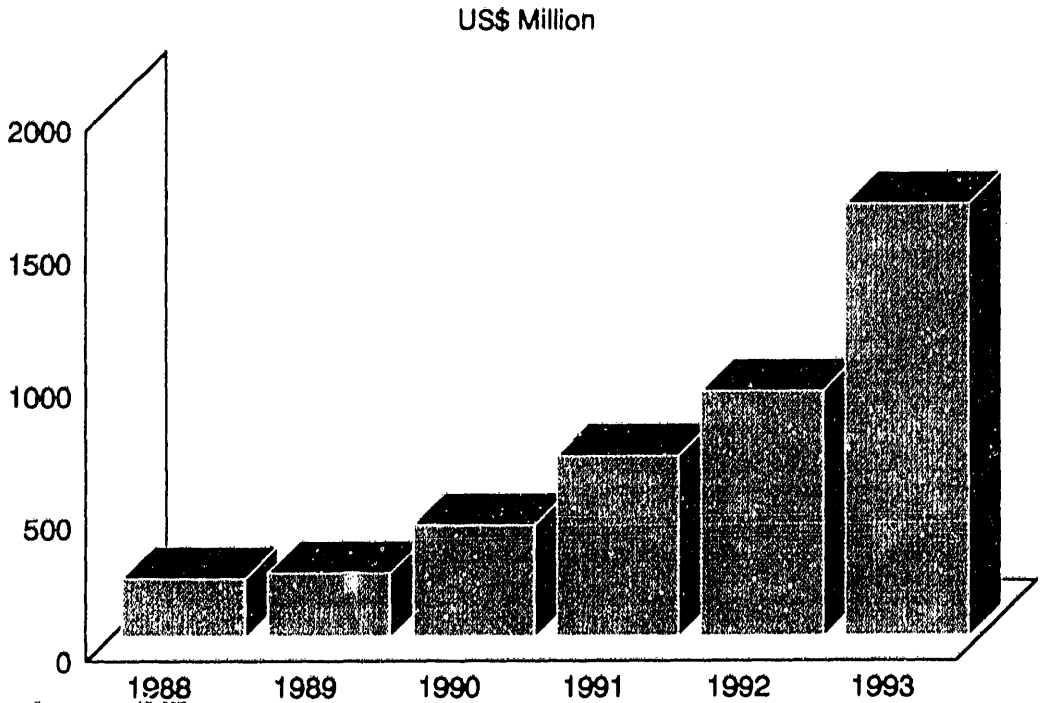
22. Remittances from Sri Lankans working abroad and official transfers increased slowly during the 1980s, resulting in a generally stable services and transfers surplus. Improving surpluses on port, transportation, insurance and travel coupled with a stable deficit on income flows have caused the services deficit to shrink since 1990. Port, transportation and insurance surplus increased from SDR9.58 million in 1990 to over SDR33 million in 1992. Surplus on travel also rose from SDR40.3 million to SDR58.3 million over the same period. Capital account flows are dominated by direct investment and by official and private borrowings and repayments. Direct investment has risen since 1990. There

have also been substantial inflows of portfolio investment following the opening up of the stock market in that year. Foreign investment escalated from SDR31.7 million in 1990 to SDR103 million in 1992, and SDR179 million in 1993. Over 40 per cent of this total investment came through the local stock exchange as portfolio investment. Net flows on borrowings have been strongly positive as disbursements have exceeded repayments. Since 1989, the balance on capital account has exceeded the current account deficit enabling the overall balance to be in surplus (see Table 4).

Reserves

23. Gross official reserves at year end increased steadily from nearly US$300 million in 1989 to US$1630 million in 1993 (Chart 3). This improvement heralded a noticeable recovery, bringing import cover up from 1.5 months in 1989 to 5 months in 1993.

Chart 3 - Sri Lanka - Gross official reserves at year end



Source: IMF

Table 4
Sri Lanka: Balance of Payments, 1989-93
(SDRs million)

	1989	1990	1991	1992	1993
CURRENT ACCOUNT	-242.7	-191.7	-351.4	-286.0	-276.0
Merchandise trade balance	-520.0	-517.8	-725.7	-721.4	-791.4
Exports	1217.0	1456.1	1490.6	1747.6	2026.7
Traditional	426.0	472.0	408.6	348.9	384.5
Non-traditional	742.0	916.0	1082.1	1397.7	1582.9
Other	49.0	68.1	0	1	59.3
Imports	1737.0	1973.9	2216.3	2469.0	2818.2
Petroleum	182.2	264.0	227.7	225.6	218.4
Services, net	-127.3	-72.1	-67.6	-23.0	4.2
Receipts	314.4	365.8	440.9	489.3	524.0
Payments	-441.7	-437.9	-508.5	-512.3	-519.8
Private transfers net	257.9	268.4	293.3	328.2	396.2
Current account (excluding official transfers)	-389.4	-321.5	-500.0	-416.2	-391.0
Official transfers, net	146.7	129.8	148.6	130.2	115.0
CAPITAL ACCOUNT	226.1	320.6	474.9	352.0	564.1
OVERALL BALANCE	-66.7	139.7	152.3	133.0	362.0
US dollars millions	*-87.7*	*198.7*	*217.8*	*187.3*	*505.5*

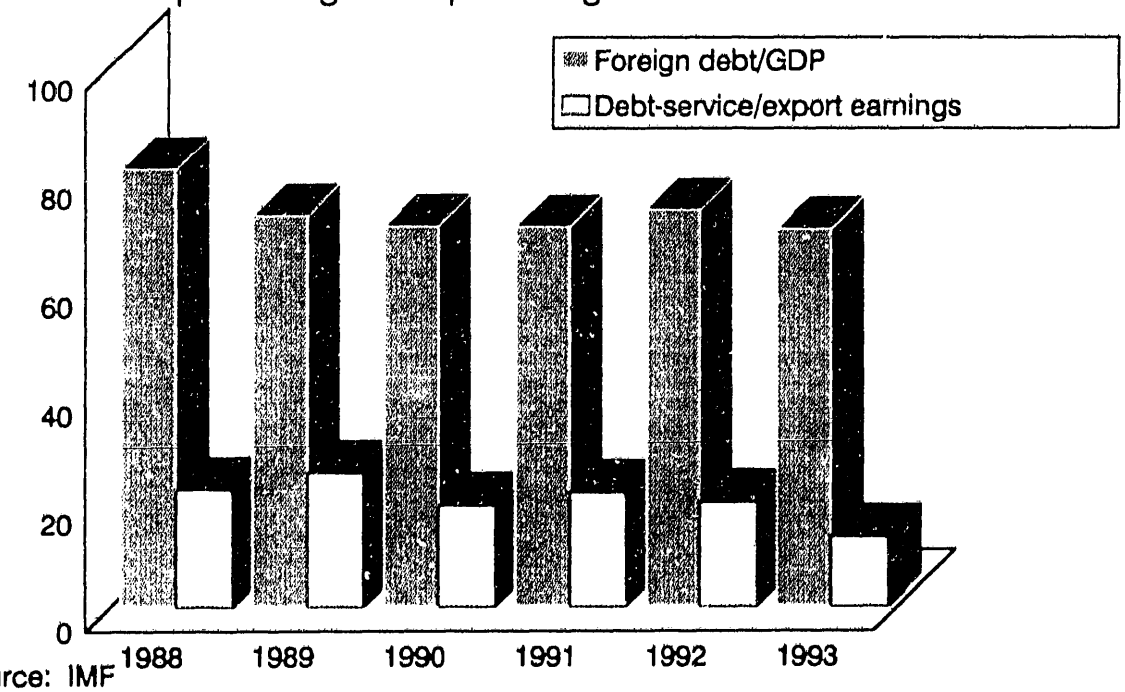
Source: IMF.

External Debt

24. The value of external debt has risen from SDR4.06 billion in 1988 to SDR4.97 billion in 1992. In terms of share in GDP this represents a decline from 81 per cent to about 73 per cent in 1992 and to nearly 70 per cent in 1993 (Chart 4). Debt servicing obligations also fell from 19.8 per cent of earnings from goods and services in 1988 to 19.4 per cent in 1992, and 12.9 per cent in 1993.

25. According to World Bank data, total external debt including private non-guaranteed debt, short-term borrowings and use of IMF credit, stood at SDR4.75 billion at the end of 1991, or 73 per cent of GNP. The existence of aid consortium led to the majority of Sri Lanka's debt being granted on concessional terms. The debt-service ratio thus remains comparatively modest by international standards even though the ratio of debt to GDP is significant.

Chart 4 - External debt as percentage of GDP and debt service as percentage of exports of goods and services



Source: IMF