

GENERAL AGREEMENT ON TARIFFS AND TRADE

RESTRICTED

L/1352

11 November 1960

Limited Distribution

CONTRACTING PARTIES
Seventeenth Session

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

C E Y L O N

1. In accordance with its terms of reference the Committee has conducted the consultations with Ceylon under Article XVIII:12(b). The Committee had before it: (a) a basic document (MGT(60)70), including as an annex the Ceylon Government Gazette No.12188, and (b) documents provided by the International Monetary Fund as mentioned in paragraph 2 below. In conducting the consultation the Committee followed the "Plan" recommended by the CONTRACTING PARTIES. The consultation was completed on 27 October 1960. The present report summarizes the main points discussed during the consultation.

Consultation with the International Monetary Fund

2. Pursuant to the provisions of Article XV of the General Agreement, the CONTRACTING PARTIES had invited the International Monetary Fund to consult with them in connection 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 the Executive Board decision relating to the last consultation with Ceylon under Article XIV of the Fund Agreement¹ and the background material prepared in connection with that consultation. The Fund has also provided a supplementary paper, dated October 7, 1960, to supply background information on recent developments.

"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 Fund draws the attention of the CONTRACTING PARTIES to the Executive Board decision of June 1, 1960, taken at the conclusion of its recent consultation with Ceylon, and particularly to paragraph 5, which deals with the restrictive system of Ceylon. Since the conclusion of that consultation, there have

¹See Annex II.

been certain developments set forth in the Fund's supplementary background paper. In the year ending June 30, 1960, Ceylon's foreign exchange reserves fell by about \$50 million, or almost 30 per cent. In August 1960 measures were taken to reduce imports. While the full effect of those measures cannot be estimated at this time, it would appear that they are not more than required to prevent a continuation in the decline in reserves.

"With respect to Part II of the Plan for Consultations, relating to alternative measures to restore equilibrium, the Fund draws attention to the decision taken at the conclusion of its last consultation with Ceylon. The Fund has no additional alternative measures to suggest at this time."

Opening statement by the representative of Ceylon

3. In an opening statement, the representative of Ceylon described recent developments in the Ceylon economy, the evolution of production, foreign trade and payments, internal measures taken recently to restore equilibrium, and future prospects. It was stated that in 1959 the gross national product increased only insignificantly, and that production of cash crops either increased slightly or declined. On the other hand, the money supply increased substantially, mainly owing to Government deficit spending. The expansionary effects of the budget deficits had influenced not so much domestic prices as the demand for imports. While exports increased somewhat over the previous year and the terms of trade improved, a steep increase in the import bill brought about the largest trade deficit on record. The current account deficits in three successive years had brought down Ceylon's external assets from Rs.1,179 million at the end of 1956 to Rs.689 million at the end of 1959. The fall in 1959 alone was of the order of Rs.195 million, a decline of 22 per cent. Excluding sinking funds, Ceylon's external assets amounted to no more than the equivalent of three months' imports. As for 1960, the first half-year saw a current account deficit even higher than that in the corresponding period in 1959, and external assets had continued their sharp decline, standing at Rs.555 million at the end of August.

4. In the face of this situation, the authorities had taken certain action, mostly in the monetary field. The rate of interest charged by the Central Bank on advances to commercial banks was raised from $2\frac{1}{2}$ to 4 per cent for all purposes other than the financing of specified essential imports and of production and distribution of domestically produced goods. Margin requirements were to be insisted upon on letters of credit opened for certain non-essential imports, and overall limits were placed on the advances that commercial banks were to make to finance these imports. The credit base for hire purchase was tightened. To supplement these internal measures, import duties on a wide range of luxury and non-essential products as well as the excise tax on tobacco were raised, as were the duties on certain exports. For the financial year 1960/61 an attempt had been made to reduce the budget deficit by significant increases in certain taxes, the incidence of which was expected to fall mainly on the more affluent sections of the community.

5. A number of long-term measures, designed to raise productivity and increase production, were provided for in the Ten-Year Plan for 1959-1968. These projects would no doubt, in time, make their contribution to the balance of payments, but in the interval would inevitably impose an immediate strain on the foreign exchange reserves. Foreign investment was expected to make only a modest contribution to the reserves. The current level of import restrictions was not high, but they might have to be intensified in the near future in view of the rapid depletion of the exchange reserves. The Ceylon representative ended his statement by explaining that the licensing system, though somewhat complex owing to the exigencies of the policy of "Ceylonization", was not intended to be restrictive.

Balance-of-payments position and prospects

6. Members of the Committee thanked the Ceylon representative for his most clear and informative statement and noted the developments in the licensing restrictions since the last consultation in 1958. Particularly welcome was the fact that Ceylon had discontinued the use of discrimination applied pursuant to Annex J of the General Agreement. They commended the Government of Ceylon for its efforts to refrain from using quantitative restrictions to meet adverse situations and expressed the hope that, in the unhappy event of further deterioration of the balance of payments, any new restrictions that might have to be imposed would be kept to the minimum and be non-discriminatory.

7. Noting that Ceylon depended for its external earnings on a few primary commodities, members of the Committee asked the Ceylon representative to comment on the future prospects for these commodities. The Ceylon representative described for the Committee the price trends of tea, rubber and coconut products in recent years. The average prices of tea had fallen steadily since 1955. The price of rubber rose significantly between 1959 and 1960 but had recently been falling from the high level reached in the first half of the year. The price of coconut oil declined noticeably in 1960 as compared with last year, and changes in the prices of desiccated coconut and copra between 1959 and 1960 were not significant. The Ceylon representative did not think the trend to be very encouraging. A member of the Committee observed that the price changes between 1959 and 1960 would not necessarily bring about a decline of export proceeds on the basis of a constant volume of exports. The Ceylon representative pointed out that export receipts depended not only on the volume of production, which was at the mercy of nature, but also on market conditions abroad which were also unpredictable. Even if exports could increase, imports were unlikely to fall. Ceylon was traditionally in deficit on invisible transactions. In the domain of investment, remittance of non-residents' capital earnings had always been a major item, and in recent years repatriation of foreign capital had been considerable, although the net outflow of private long-term capital had slowed down in the last two years.

8. A member of the Committee referred to the very small and erratic inflow of capital in recent years and asked whether the Government had envisaged any policy or measures to encourage the inflow of foreign capital which, in view of the very low level of domestic saving, must be indispensable to the

implementation of the Ten-Year Plan. The representative of Ceylon stated that the Ten-Year Plan had been formulated fundamentally on the basis of domestic resources and presupposed only a moderate availability of foreign capital. As regards Government policy, the Finance Minister, in his recent budget speech, had assured foreign investors that investment would be welcome in all fields other than those reserved for the public sector. Remittance of profits would be free of restriction and, in the case of approved foreign investments, repatriation of capital would also be unrestricted.

9. In reply to a question, the Ceylon representative supplied statistical information on the composition of Ceylon's total imports. These showed that in recent years there had been a significant shift in imports from consumer goods to capital equipment, semi-manufactures and basic foodstuffs (transport equipment, fertilizers, rice and flour).

Internal fiscal and monetary measures

10. Members of the Committee noted with satisfaction the readiness on the part of the Ceylon Government to rely on fiscal and monetary measures which so far had enabled it to avoid the intensification of quantitative restrictions. The Government was evidently aware of the desirability of following liberal trade policies and of restoring equilibrium through the adjustment of internal demand. They hoped that the measures taken in August and the new budget policy announced in September would be successful and effective so that there would be no need to intensify the import restrictions. They also expressed the hope that in case these measures should turn out to be inadequate, the Ceylon authorities would explore other internal measures to restrain demand before resorting to import restrictions.

11. Asked to comment on the effect of the measures taken in August, the Ceylon representative replied that, as the Committee was aware, such measures usually take some time to exert their effects on the economy. The measures taken were very comprehensive and in some aspects very severe, but it was difficult to foresee with any degree of accuracy their effects on demand. Ceylon would not lose sight of the possibility of using further measures in the internal fiscal and monetary field, but some intensification of the import restrictions, consistent with the criteria of Article XVIII:B, might well be inevitable.

System and methods of restrictions

12. The representative of Ceylon drew attention to the Import Control Notice No.31/60 contained in Ceylon Government Gazette No.12188 of 27 August 1960, which set out the present control system in Ceylon with full indication of the restrictions applying to individual items. The Ceylon representative also gave an exposé of the system and explained that although the control procedures appeared complex and the coverage comprehensive, effective restriction had been reduced to a minimum. Only a handful of items were not being allowed in freely, the licensing arrangements being maintained principally for the

purpose of implementing the Government policy of "Ceylonization" of foreign trade. In August, a few items were placed under licensing control, but the intention was not primarily to intensify significantly existing restrictions.

13. Some members of the Committee considered that while the general level of the restrictions was clearly not excessive in relation to the balance-of-payments position, there seemed to be an element of de jure discrimination which, though not intended as such, could not but have made the market less accessible to the exports of some countries than to those of others. For example, for a wide range of products, imports from a number of countries were admitted under General Licence, while an individual licence was required if they originated in the dollar area. It further appeared that individual licences were not issued automatically to the full amount applied for by non-Ceylonese traders.

14. The Ceylon representative reaffirmed the position that the use of different licensing procedure for imports from different areas was closely related to the aim of "Ceylonizing" foreign trade, described the background of that policy and explained why the measures at present taken for that purpose, while having no restrictive effects on imports, appeared to be discriminating against imports from certain countries. It was noted that as a legacy of the past a substantial proportion of the country's external trade had been in the hands of foreign firms. Having achieved independence it was natural for the people to wish to participate more fully in this important branch of the economy. In preference to more drastic measures, such as outright expropriation of foreign firms, the present method of "Ceylonization" had been adopted. This aimed at achieving the desired end of diverting trade to nationals while affecting to the least possible extent the interests of established firms. By and large the area in which importers and exporters of Ceylonese nationality were encouraged to participate at present was limited to "new trade" in the sense of trade with countries with which there had previously been no substantial transactions, or with which trade had been substantially interrupted during the war. In certain other cases, e.g. in the trade with the United States, the aim was to enable Ceylonese citizens to benefit from any expansion of trade between the two countries. The differences in the procedures for admitting imports from different countries only resulted from the transitional nature of the present arrangements; the methods would be uniform once the Ceylonese policy was completed, since it was the intention of the Ceylon Government to "Ceylonize" trade with all countries over a period of time. At the present time, in the view of the Ceylon delegation, there was no question of discrimination because there was no effective restriction on imports, and the application of such internal regulations should not be regarded as being in conflict with the provisions of the General Agreement.

15. Replying to a question, the Ceylon representative stated that the ultimate aim was to divert all foreign trade into the hands of Ceylon citizens. It should be noted, however, that the definition of "Registered Ceylonese Trader" for this purpose was a liberal one; although individuals must be citizens of Ceylon in order to qualify, a firm would qualify provided a minimum of 51 per cent of its share capital were held by citizens of Ceylon, and if the requisite proportion of its directors and employees were Ceylon citizens.

16. The Committee discussed with the Ceylon representative the control or restrictions applied to certain individual items with a view to clarifying their purpose. Members of the Committee commented on the rather cumbersome nature of the whole system of Ceylon's import restrictions. They were aware that the complicated system had resulted from modifications and changes made in the course of years to meet the requirements of new situations, but felt that in the interests of foreign exporters as well as the local trading community the system could be simplified and made more intelligible. Some members also suggested that the Ceylon Government should explore ways of achieving the declared purpose of "Ceylonization" without having to retain the discriminatory features in the licensing procedure. The representative of Ceylon stated that the procedures applicable to "Ceylonization" policy were, in his opinion, not discriminatory and, in the nature of the case, were unavoidable. He also added that, since the last consultation, the authorities in Ceylon had published a Gazette notification, giving details of the control system in a more coherent and simplified form. Further, adequate publicity was given of changes made from time to time.

Effects of the restrictions

17. Some members of the Committee referred to the provisions of paragraph 10 of Article XVIII and enquired whether provision had been made in the import licensing system to enable the import of token quantities of products subject to restriction. They pointed out that severe quantitative restrictions, especially if amounting to prohibition, apart from any inflationary effects that might be caused by the ensuing shortage, were likely to afford incidental protection to domestic industries. One of the surest methods of preventing this was to allow some imports of all products. The representative of Ceylon stated that while appreciating the value of allowing token imports, his Government found it difficult to put this into practice principally because of the administrative complications that would be involved. At present there were only a very small number of items the import of which was prohibited. Although admittedly the provision of token imports for these few products would not create any significant pressure on the balance of payments, the administration of any such token import system would place a very heavy burden on the Government department concerned, in addition to the difficulty of allocating licences in a fair manner for a very small quantity of imports. The Government of Ceylon was fully aware of the desirability of avoiding giving protection to uneconomic industries.

General

18. Members of the Committee thanked the representatives of Ceylon for the open and frank manner in which they participated in this consultation, which had proved to be an occasion for a useful exchange of views. The Committee welcomed the extensive internal fiscal and monetary measures recently taken by the Ceylon authorities, which had enabled the Government to avoid the use of further import restrictions. It was generally hoped that the measures taken would enable the Government to avoid the intensification of restrictions and that in case there should be any further deterioration of the reserve position resort should be had

to measures in the fiscal or monetary field rather than to import restrictions. The Committee urged that, if further restrictions should prove inevitable, these should be kept to the minimum and be non-discriminatory. The Government of Ceylon was also asked to explore the possibility of simplifying the import control system and of eliminating any incidental discriminatory elements therein.

19. The representative of Ceylon stated that his delegation had taken careful note of the views and suggestions that had been expressed at this consultation and that these would be reported to his Government, which would no doubt give them careful consideration.

ANNEX I

Opening Statement by the Representative of Ceylon

I propose to review very briefly the background of economic events in Ceylon in the recent period in order that the Committee may appreciate the significance of the current level and methods of import restrictions in Ceylon and assess developments in their proper perspective.

The Gross National Product at constant 1956 prices, as provisionally estimated, increased to Rs.5,441 million in 1959, an increase of 3.8 per cent in real terms over the previous year. When allowance is made for a population growth of 2.5 per cent, however, the per capita growth of real product is 1.3 per cent, which by any standard is very low indeed. Production of tea, which accounts for around two-thirds of our total foreign exchange earnings, recorded an increase of 2 per cent over 1958. Of the other two major foreign exchange earners, viz. coconut and rubber, the former registered an increase in production of 13 per cent, while production of the latter, due to adverse weather conditions and the replanting of old trees, declined by 8 per cent. Paddy production suffered a decline of about 3 per cent as compared with the previous year, due also to unfavourable weather conditions. The ratio of export production to Gross National Product at 29 per cent showed little change as compared with the previous year.

I would now like to dwell briefly on events in the monetary and fiscal spheres before dealing with developments in the external situation. Notwithstanding the contractionary effect of a very sizeable drain on our foreign reserves (to which I shall refer at some length later) and some rise in fixed and savings deposits, the money supply increased by Rs.101 million or 9.4 per cent in 1959, as compared with an increase of Rs.37 million or 3.6 per cent in 1958. The main expansionary influence derived, as in the case of the previous year, from the Government's budgetary operations. These operations for the financial year 1958-59 resulted in a net cash operating deficit of Rs.413 million, the highest on record. This deficit compared with deficits of Rs.222 million in 1957/58 and Rs.196 million in 1956/57. The direct inflationary impact of this deficit of Rs.413 million, as measured by the net borrowing of the Government from the banking system plus the decline in the Government's cash balances, was Rs.241 million in 1958/59 as compared with Rs.108 million in 1957/58. A redeeming feature, however, was that Government borrowing from non-inflationary domestic sources, i.e. non-bank sources, amounted to Rs.109 million, a six-fold increase over the previous financial year. Foreign borrowing accounted for a further Rs.36 million, as compared with Rs.24 million in the previous year.

As regards the financial year 1959/60, the estimated budget deficit has been of the order of Rs.370 million, and available statistics indicate that the actual deficit at the end of the first half-year has been Rs.149 million.

I may add that these successive budget deficits have caused the present Government very considerable concern inasmuch as they have assumed their present proportions before the planned development of the economy had made any real progress. What is important is that in the conditions of the Ceylon economy deficit financing has had its impact not so much on domestic prices (indeed, retail prices rose by only 0.2 per cent in 1959 and wages also remained relatively stable) as on the demand for imports with its inevitable consequences for the balance of payments.

As regards the external situation, while exports did reasonably well last year and were, at Rs.1,754 million, higher than those of the previous year by Rs.43 million, Ceylon registered in 1959 a foreign trade deficit of Rs.251 million - the largest in its economic history. This deficit, which occurred in the face of an improvement in the terms of trade, was the result of a steep increase in the import bill by Rs.288 million to Rs.2,005 million, the highest level ever recorded. The years 1957 and 1958 were also years of trade deficits but of much smaller proportions, viz. Rs.122 million in 1957 and Rs.6 million in 1958.

Ceylon's balance of payments on current account recorded a deficit of Rs.206 million in 1959, the main contributory factor being the sharp expansion in imports. This follows upon deficits of Rs.195 million in 1957 and Rs.153 million in 1958. These successive deficits have caused a serious drain on our external assets, which have fallen by Rs.490 million during this period to the low level of Rs.689 million at the end of 1959. The fall in 1959 alone was of the order of Rs.195 million, a decline of 22 per cent. If holdings on account of sinking funds are excluded from these assets, these amounted at the end of the year to no more than the equivalent of three months' imports.

Prospects for the balance of payments for 1960 are not encouraging. Provisional estimates for the first half of the year indicate a current account deficit of Rs.91 million as compared with a deficit of Rs.83 million in the corresponding period of 1959. External assets have continued their sharp decline and by the end of August had fallen by a further Rs.133 million to Rs.555 million, their lowest level in the post-war period.

In order to arrest this deterioration in our external situation and conserve available foreign exchange resources for essential purposes, the Central Bank introduced certain monetary measures with effect from 13 August this year. It raised its rate of interest on advances granted to commercial banks from $2\frac{1}{2}$ per cent to 4 per cent. However, in order that the cost of credit needed to finance specified essential imports (including food, textiles, fertilizer and pharmaceutical products) and also the production and distribution of domestically produced goods may not be adversely affected, the Central Bank continued to grant accommodation to commercial banks to meet these particular requirements at $2\frac{1}{2}$ per cent. Commercial banks were also instructed to insist on specified margin requirements for letters of credit opened by importers for certain categories of non-essential imports, including alcoholic beverages, motor cars, air-conditioning equipment, watches, furniture and photographic goods. Overall limits were placed on the advances commercial banks were to

make available to finance these imports. Restraints were also imposed on the expansion of commercial bank credit for the finance of hire-purchase transactions. These measures were reinforced by increases in import duties on a wide range of luxury or otherwise inessential imports. These included confectionery, beer and spirits, tobacco, perfumery and cosmetics, watches, specified items of textiles and motor cars. The excise duty on tobacco was raised, and export duties on cinnamon quills, coir fibre and papain were also increased.

Far more far-reaching, however, have been the taxation proposals announced by the Finance Minister in his budget speech delivered on 15 September in respect to the new financial year. The new budget provides for a deficit of Rs.470 million on the basis of existing taxes, but additional taxes are expected to yield Rs.130 million thereby reducing the deficit to Rs.340 million, which is to be financed by domestic borrowing and, to a lesser extent, by foreign loans. Hitherto attempts to bridge budget deficits by the provision of additional taxation have been quite modest, and have yielded no more than Rs.30 million on the average. The present attempt, therefore, to obtain Rs.130 million from new taxation represents a significant departure from established fiscal policy and a determined endeavour to increase Government revenues to levels more in accord with the increasing scale of Government activity in the field of social services and in economic development. These new taxation proposals, though severe on the more affluent sections of the community, are not expected to cause undue hardship and will not have the effect of increasing the cost of living. They include a Land Tax of Rs.15/- per acre payable by individuals owning 100 acres of land and over, a Companies Tax of Rs.50 on every Rs.10,000 of nominal share capital, a Business Names Registration Tax, a Professions Tax on accountants, consulting engineers, government building contractors, western medical practitioners and lawyers, and a surcharge on income tax of 15 per cent.

These measures, Mr. Chairman, are expected to exert a corrective influence on the balance of payments. Long-term measures, designed to raise productivity and increase production in the domestic as well as export sectors of production and to diversify the economy by the establishment of new industries, are being pursued within the framework of the Ten-Year Plan formulated for the period 1959-1968. The Tea, Rubber and Coconut Rehabilitation Schemes, which subsidize the replanting of old plantations and also the use of fertilizer, are expected to increase significantly the export capacity of these principal foreign exchange earners. In the field of industrial production, the country's two sugar factories have begun production this year. A chemicals factory for the manufacture of caustic soda, chlorine and other chemical products have also begun production. Provision has been made in the new budget for the expansion of the country's only cement factory from its present capacity of 80,000 tons to 250,000 tons, and for the establishment of a second factory with a capacity of 200,000 tons. Current plans envisage the achievement of near self-sufficiency in this product in four years time. Investment in the salt industry, which we expect to be a potential foreign exchange earner, is also being expanded, and we hope to export salt in considerable quantity in the course of the next year. Provision has also been made for the completion of the Mineral Sands Refinery, the entire output of which, consisting of ilmenite, rutile and zircon, will be available for export. A spinning mill

with a capacity of over 2 million pounds of yarn is expected to come into production shortly, and plans are under way for the establishment of an iron and steel factory, a motor car tyre and tube factory and a fertilizer factory. These and other projects which the Ten-Year Plan envisages will no doubt take time, Mr. Chairman, before they can reach fruition and make their contribution to the balance of payments. In the interval, the investment expenditures incurred and their secondary effects must necessarily impose an immediate strain on available foreign exchange reserves.

Foreign investment, while welcome for productive purposes in fields other than those reserved for the expansion of the public sector, is not expected to make anything but a modest contribution to the solution of the foreign exchange problem. Last year the inflow of private capital for direct investment was extremely small, amounting to only Rs.1.7 million.

As regards the system of import restrictions and their current level, these are covered very adequately in the very comprehensive information contained in the documentation already made available to the Committee by the GATT secretariat and the International Monetary Fund. The current level of restrictions is not high, and may well need to be intensified in the near future in view of the rapid depletion of our foreign exchange reserves. The licensing arrangements are no doubt somewhat complex, but this complexity derives from the ramifications of the Government's policy of Ceylonization of the import trade and not from any high degree of restrictiveness of the licensing system.

ANNEX II

IMF Executive Board Decision of 1 June 1960 relating to Ceylon

1. The Government of Ceylon has consulted the Fund under Article XIV, Section 4, of the Fund Agreement concerning the further retention of its transitional arrangements.
2. With the rise in export earnings from tea and coconut products, and a substantial increase in paddy output, Ceylon's national product increased moderately in real terms in 1958. There was a further slight improvement in 1959, owing mainly to the increased volume and value of coconut exports. Tea exports, however, declined in 1959.
3. During the period from 1956-57 to 1958-59, the over-all cash operating deficit increased continuously as a result of the substantial increases in government expenditure. This growing deficit necessitated recourse to Central Bank credit and led to a large expansion in money supply. Notwithstanding a budgeted increase in tax revenues, a large deficit is also envisaged by the Government for 1959-60. The Fund believes that Ceylon should make every effort to reduce the deficit.
4. Although the strain on Ceylon's balance of payments was somewhat reduced in 1958 and 1959, the position on the merchandise account deteriorated in 1959, but there was an improvement in the first quarter of 1960. The loss of foreign exchange reserves during 1959 was much larger than in 1958 and calls for corrective measures.
5. There was some intensification in 1959 of restrictions on payments for certain current invisibles. Ceylon, however, has eliminated the discriminatory features of such restrictions, thus achieving the elimination of discrimination with respect both to restriction on payments for imports and invisibles, and the Fund welcomes this progress. The Fund notes the intention of Ceylon to keep under review its bilateral trade and payments agreements, especially as to their possible discriminatory effect.
6. In concluding the 1959 consultations, the Fund has no other comments to make on the transitional arrangements maintained by Ceylon.