GENERAL AGREEMENT ON

TARIFFS AND TRADE

RESTRICTED

BOP/W/144

5 March 1992

Limited Distribution

Committee on Balance-of-Payments Restrictions

1991 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 26S/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, 1979, 1981, 1983, 1985, 1987 and 1989 (BOP/R/187).

II. Sri Lanka's trade policy and recent changes

4. Most imports are free from restriction. The current coverage of import licensing and other restrictions applied by Sri Lanka is contained in Annexes I-V to the Sri Lankan Statement for this consultation (BOP/307). Broadly, import licensing covers certain foods and preparations (including crustaceans, milk, vegetables, maize, rice), spirits, tobacco, petroleum products, certain elements, chemicals, medicaments and disinfectants; jewellery; motor vehicles; aircraft; colour photocopying machines; and arms. State-trading restrictions apply to imports of products listed in Annex III to the Sri Lankan Statement; Annex V covers products which may only be imported with the recommendation of the appropriate State body.

92-0268

5. Most imports, except for those by export-processing industries, must be made against sight letters of credit valid for 180 days. Export-processing industries may import under any means of payment. Deposits of 100 per cent on letters of credit for luxury consumer goods, introduced in 1989, remain in force. The items covered include electrical, gas or mechanical domestic appliances, refrigerators and air-conditioners, sanitary ware, alcoholic drinks, tobacco, computers and peripherals, furniture and household equipment, glassware, electric lamps, detergents, motor vehicles, perfumes and cosmetics, photographic equipment, radios and televisions, video cassettes, watches and clocks, and carpets and other floor coverings.

6. Over the time, Sri Lanka has considerably liberalized its trade policies in an attempt to diversify and regenerate its economy. However, the country's economic management possibilities remain constrained by such factors as the course of world prices for traditional exports such as tea, rubber and coconut products; the evolution of trade policies and measures in partner countries, particularly as regards restraints on trade in clothing; the development of remittances of income from Sri Lanka residents overseas; the perceived need to maintain a high degree of self sufficiency in rice and other basic supplies; and the evolution of foreign aid and investment, the latter being itself considerably dependent on domestic political stability.

7. Tariffs range generally from 10 to 50 per cent, with a 100 per cent rate on luxury goods. A 5 per cent import surcharge is generally in force. Modifications since 1989 aim to reduce rates of effective protection, with the objective of a simplified four-band tariff structure with a maximum 35 per cent rate. In 1991 the maximum rate was generally reduced to 50 per cent. Passenger cars still retain a high duty of 200 per cent.

III. Economic and trade developments

(a) Introduction

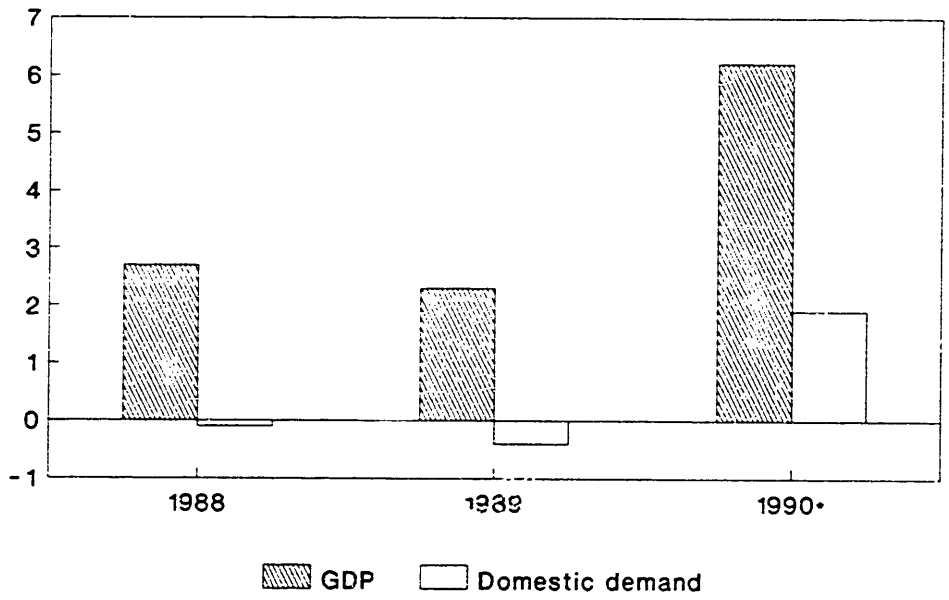
8. Since 1988, Sri Lanka has applied a number of policies seeking to correct re-emerging macro-economic imbalances. The authorities have reduced the overall fiscal deficit, controlled the expansion of liquidity more closely and initiated reform of the financial market. Fiscal revenue collection has improved and some progress in reducing expenditures (albeit in capital expenditure) has been made. As a result, the current account deficit diminished and the level of international reserves recovered somewhat from its record low in mid-1989. Export performance has improved, largely due to liberalization measures taken in the exchange and trade régimes. Nevertheless, the export sector continues to suffer from

revenue instability, caused by concentration on a small group of export commodities.

(b) Aggregate supply and demand

9. In 1989, economic growth was moderate at 2.3 per cent, but picked up in the second part of the year as civil unrest stopped and business confidence recovered. Growth had its origin largely in external demand pressures, with domestic demand stagnant (Chart 1), due to the drop in public sector investment that resulted from fiscal policy restraint. Agricultural production declined 1.1 per cent largely as a result of a drought. Total industrial production was up nearly 4½ per cent, with rapid growth in the private export sector, while public sector industrial output declined by 21 per cent. Both sectors were negatively affected by civil unrest, disrupting work and transportation. The service sector grew by 3.2 per cent in 1989, although tourism and transport suffered from civil unrest in the south. Construction activity declined due to the curtailment of public investment expenditure.

Chart 1 - Sri Lanka - Real GDP and domestic demand
(Annual percentage change)



*Provisional.
Source: IMF.

10. In 1990, growth was brisk, at an estimated 6.2 per cent. Domestic demand recovered, growing by an estimated 2 per cent while the resource gap fell nearly 30 per cent.[1] Gross fixed investment grew more than 1½ per cent after four years of decline. Consumption was up 2 per cent, and exports of goods and non-factor services rose almost 11 per cent. Preliminary information on the output side show that agricultural production recorded a significant growth of nearly 9 per cent. Favoured by a more stable political situation, public sector industrial output is estimated to have increased more than 19 per cent in 1990. Construction activities also recovered, as did tourism and transport services.

(c) Price developments

11. In 1989, inflation as measured by the Colombo Consumer Price Index (CCPI) was stable at about 15 per cent, while the GDP deflator increased to 10.9 per cent from 9.9 per cent the previous year. Increased inflation (as measures by the GDP deflator) occurred mainly in the second part of 1989, as civil unrest, the drought, and stabilization measures (including the elimination of several food subsidies and increased in administered prices) in the context of excess liquidity, put upward pressure on prices.

12. In 1990, the rise in the CCPI accelerated to 19.6 per cent (it peaked in July when the 12-month average reached 24 per cent) and the GDP deflator recorded a rise of 20 per cent. However, after the full effect of the rise in domestic petroleum prices and public transport fares was felt in September, inflation pressures started abating in the last quarter of the year. This development was helped by the absence of major changes in the rupee exchange rate during 1990. During December 1990, the CCPI rose less than 2 per cent. Preliminary information for the first 4 months of 1991, shows a decline in inflation to an annualized average of 5.3 per cent.

(b) Public finances

13. The fiscal deficit (after grants) of Sri Lanka in 1989 declined substantially to 8.7 per cent of GDP from more than 12½ per cent in 1988 (Chart 2).[2] The improvement resulted from both a significant rise in revenue to 21.4 per cent of GDP (18.8 per cent in 1988) and a contraction in expenditure to 32.6 per cent of GDP (34½ per cent in 1988). Revenue

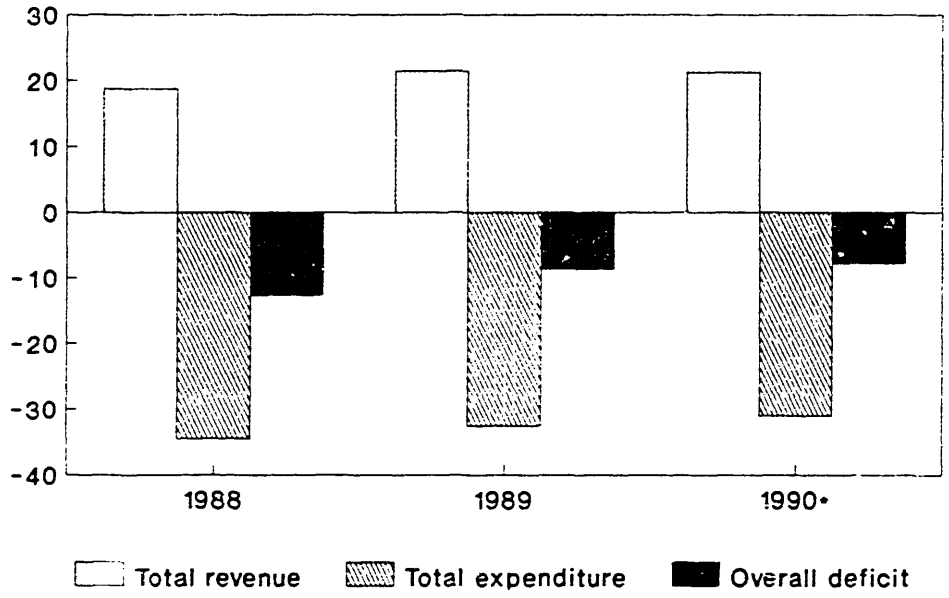
---

[1] In National Account Statistics, resource gap is the difference between exports and imports of goods and non-factor services.

[2] Government finances comprise the consolidated central government operations and extra budgetary accounts.

increase partly reflected one-off measures, like a tax of 9 per cent on Central Bank holdings of treasury bills, but also better collection of taxes and high import tariffs.[3] Expenditure reductions were concentrated in capital expenditure and net lending, while current outlays rose moderately as a result of wage increases, growth of the civil service, and an increase in subsidies and transfers to households and State-owned corporations.[4] Capital expenditure declined, partly as a result of expenditure restraint measures that affected capital transfers to public corporations. The structure of deficit financing changed slightly. Recourse to foreign financing declined by nearly 1 per cent of GDP. However, the share of net domestic borrowing in deficit financing fell to about 56 per cent from 60½ per cent in 1988. Net borrowing from the banking system was negative as amortizations exceeded new borrowing.

Chart 2 - Sri Lanka - Summary of central government public finances
(Percentage of GDP)



•Actual.
Source: IMF.

[3]The average nominal tariff increased to 18 per cent from 15 per cent in 1988.

[4]Transfers to public enterprises fell by about 1 per cent of GDP during 1989. The government has undertaken a periodic review of the prices of public-sector goods and services. Furthermore, it has successfully restructured and privatized a number of public companies.

14. The 1990 budget outcome showed a further reduction of the overall deficit to 7.8 per cent of GDP. Both revenue and expenditure shares in GDP declined to 21.2 per cent and 31.1 per cent respectively. Again, the decline in total expenditure was nearly all in capital expenditure, while there were significant increases in defense and public order outlays and on two new social welfare programmes. Revenue rose nearly 26 per cent mainly as a result of higher excise duties on tobacco and liquor, higher business turnover taxes, and collection of tax arrears. As the share of foreign financing of the deficit rose to more than 46 per cent, domestic borrowing declined to 54 per cent of the overall deficit or just 4.2 per cent of GDP. The 1991 budget has continued the reduction in the deficit through a programme of cuts in current expenditures and a number of tax and tariffs reforms aimed at increasing the efficiency of the tax system.

(e) Money and credit

15. In the first half of 1989, sluggish output growth, together with excess liquidity led to accelerated inflation and caused a decline in international reserves. To counter this, the government undertook a number of measures including open market sales of treasury bills to the non-bank sector, an increase in margin deposit requirements and the reimposition of selective commercial bank credit ceilings (comprising about 40 per cent of total bank credit). The net contracting effect of those developments on reserve money growth was seen in the third quarter of the year (Table 1). Similarly, the growth of narrow money decelerated as portfolio preferences of the private sector shifted to interest-bearing deposits, partly due to increased returns. Subsequently, the growth of broad money also decelerated to record an overall increase of 11.3 per cent in 1989, compared to 16.6 per cent in 1988.

Table 1 - Sri Lanka - Changes in reserve money and domestic liquidity
(Annual percentage change)

	1988	1989	1990	June 1990	June 1991
Reserve money	32.6	4.8	17.9	14.9	25.8
Broad money	16.6	11.3	20.1	16.8	17.8
Narrow money	29.1	9.1	12.8	13.6	14.3
Currency	37.0	6.3	12.6	11.9	11.4
Demand deposits	19.9	13.0	13.2	15.9	18.1
Quasi-money	7.1	13.3	26.4	19.6	20.7

Source: IMF.

16. During the first quarter of 1990, a large increase in net foreign assets boosted reserve money. The growth of monetary aggregates also accelerated due to the increase in credit to the private sector. In the second quarter, the Central Bank started to reduce liquidity through open market operations and other measures. After recording moderate growth during the third quarter of 1990, reserve money growth accelerated again in the last quarter largely as a result of the growth in net claims on the central government. Following stagnant growth in broad monetary aggregates during the second quarter of 1990, liquidity (notably quasi-money) expanded again as a result of the increase in credit to the private sector and to non-financial public enterprises. The year 1990 as a whole saw a significant acceleration in narrow money, relative to 1989. In the first half of 1991, the monetary authorities took measures to restrict private credit growth. However, additional credit to public corporations and a strengthened balance of payments position increased liquidity.

(f) Balance of payments

17. Basic macro-economic imbalances, that re-emerged in the second part of the 1980's, limited progress in the diversification of the export base, and the recent increase in civil unrest, help explain the vulnerability of Sri Lanka's external account. In 1990, the balance of payments was also negatively affected by the crisis in the Gulf as petroleum prices increased and workers' remittances fell. Nevertheless in 1990, the overall balance of payments turned positive for the first time in recent years (Table 2). As a result the level of international reserves (excluding gold) rose to SDR 297 million, equivalent to 1.8 months of imports (Chart 3). At the end of November 1991, the stock of international reserves was about SDR 390, equivalent to nearly 2½ months of imports.

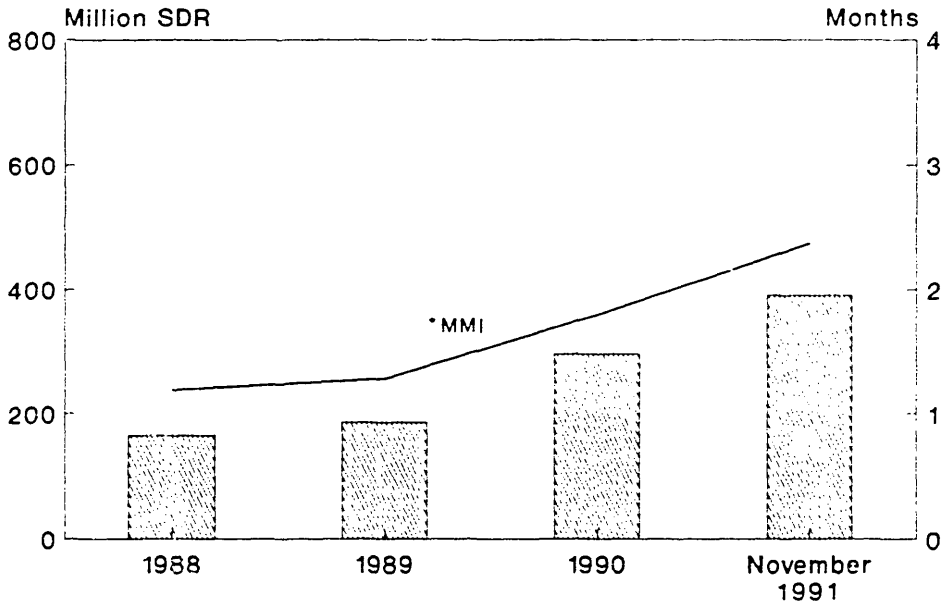
Table 2 - Sri Lanka - Balance of payments
(Million SDRs)

	1988	1989	1990
Trade balance	-568	-520	-519
- Exports	1 098	1 217	1 461
- Imports	-1 666	-1 737	-1 979
Services, net	-117	-123	-65
Private transfers	238	258	274
Official transfers, net	154	146	131
Current account	-294	-239	-178
Medium- and long-term, net	181	155	245
- Private sector[1]	-30	-34	-36
- Government	179	175	266
- Direct investment	32	14	15
Private short-term, net[2]	12	73	50
Capital account	193	227	294
Errors and omissions	37	-55	14
OVERALL BALANCE	-64	-67	130

1Consists of public corporations and private companies.
2Consists of trade credits, short-term borrowings of public corporations and private corporations, and liabilities to the foreign currency banking units.

Source: IMF.

Chart 3 - Sri Lanka - International reserves (excluding gold)



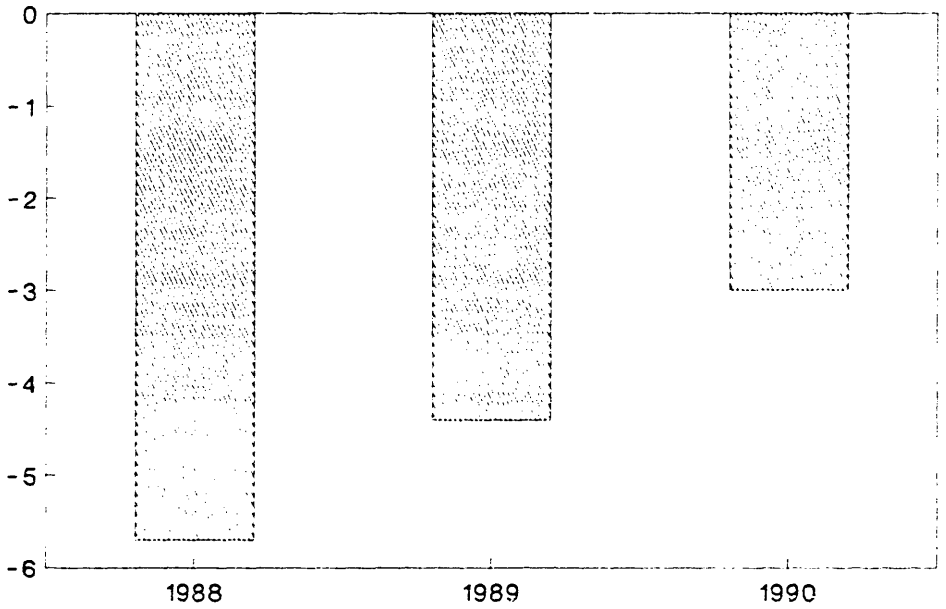
*MMI refers to equivalent months of merchandise imports. The figure for November 1991 is based on 1991 imports.

Source: International Financial Statistics, IMF, January 1992.

(g) The current account

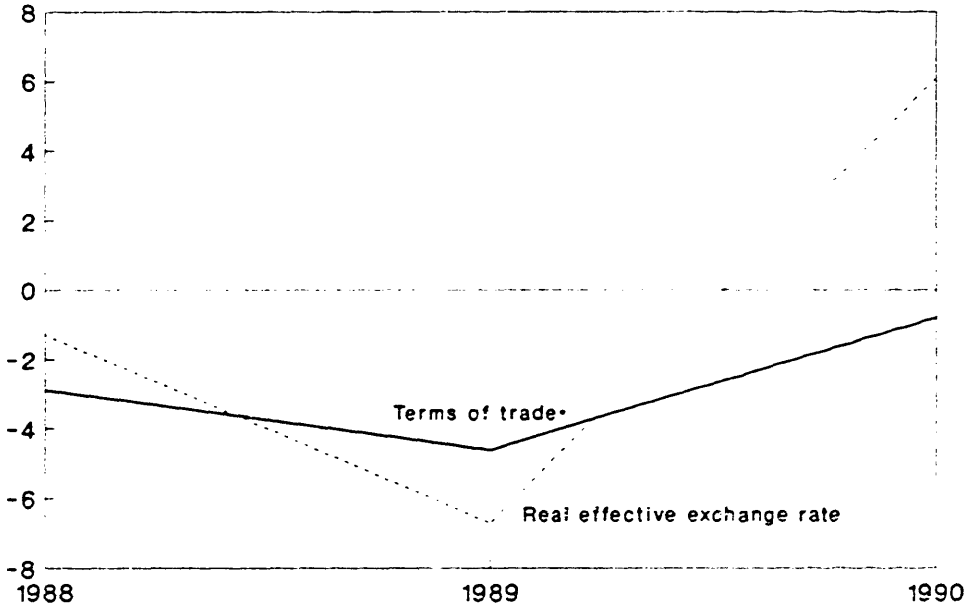
18. In 1989, the current account deficit narrowed to SDR 239 million (4.4 per cent of GDP) from almost SDR 300 million in 1988 (5.7 per cent of GDP) (Chart 4), aided by tighter fiscal and monetary stances, a rupee devaluation (Chart 5), a rise in tea prices, a large increase in the growth rate of merchandise exports, and favourable weather conditions. The deficit on merchandise trade improved to SDR 520 million from SDR 568 million in 1988, while the services deficit worsened slightly.

Chart 4 - Sri Lanka
Current account balance
(Percentage of GDP)



Source: IMF.

Chart 5 - Sri Lanka - Real effective exchange rate and terms of trade
(Averages, annual percentage change)



*The terms of trade refer to the ratio of the unit value of exports to the unit value of imports.

Source: IMF.

19. In 1990, the deficit on current account fell further to less than SDR 180 million (or 3 per cent of GDP). The trade deficit was unchanged. The services balance improved, due largely to a recovery in tourism.

20. The value of merchandise exports increased by 11 per cent in 1989, entirely due to volume growth. Exports of coconut and coconut products increased significantly due to better weather conditions (Table 3). Exports of rubber declined as more rubber manufactures were exported. The export of industrial products continued to grow strongly, especially gems, garments and textiles. The volume of merchandise imports was stable in 1989, but due to price increases, the import bill grew by almost 4½ per cent. The volume of imports of intermediate goods (especially petroleum products, fertilizers and textiles) and investment goods fell or stagnated. Credit restrictions, the introduction of a 100 per cent deposit for importing non-essential items, and civil disturbances that affected investment plans, reduced imports. Imports of rice and wheat recorded large increases both in volume and value.

Table 3 - Sri Lanka - Composition of exports and imports
(Percentage shares)

	1988	1990
EXPORTS		
Traditional exports[1]	37.4	32.3
of which: tea	26.2	24.9
Nontraditional exports[2]	57.8	62.7
Other agricultural products	5.5	4.0
Garments and textiles	30.4	31.6
Gems	7.9	8.3
Other industrial products	9.6	11.0
Other	4.4	7.8
Petroleum products	4.8	5.0
Total exports	100.0	100.0
IMPORTS		
Food	18.3	18.9
Petroleum	9.8	13.3
Textiles	12.4	10.2
Other intermediate goods[3]	29.3	27.4
Investment goods	17.0	17.8
Other	13.2	12.4
Total imports	100.0	100.0

1Consists of tea, rubber, coconuts and coconut products.
2Excludes petroleum products.
3Includes fertilizers.

Source: IMF.

21. The value of merchandise exports in 1990 is estimated to have grown 20 per cent. Export volume grew by some 13 per cent, and there was a reversal in the trend in export prices, which were up 6 per cent. Agricultural exports grew nearly 11 per cent, largely as a result of volume and price increases for tea. The value of industrial products rose nearly 21 per cent, with volumes up across the board. The fastest growing industrial sectors were other industrial products, garments and textiles. The value of merchandise imports is estimated to have increased nearly 14 per cent in 1990 due to both a rise in import volume of 6 per cent and a rise in prices. Imports of investment goods (notably machinery and transport equipment) and of intermediate goods (especially crude petroleum and fertilizers) rose as a consequence of growth in aggregate demand. In the first quarter of 1991, the value of merchandise exports is estimated to have continued its strong growth, rising 11½ per cent relative to the same period in 1990. The value of merchandise imports rose more than 12 per cent in the first quarter of 1991 with respect to the same period in 1990.

22. The services deficit widened moderately to SDR 123 million in 1989. A rise in receipts resulted largely from the recovery of tourism as civil unrest diminished in the latter part of the year. This increase was more than offset by higher net insurance and freight payments. Workers' remittances declined, reflecting the slowdown in economic activity in the Middle East. In 1990, the services deficit balance was halved, largely as a result of the recovery in tourism.

(h) <u>The capital account and international indebtedness</u>

23. In 1989, capital inflows rose to SDR 226 million from SDR 193 million in 1988, mainly due to an increase in short-term flows. However, foreign direct investment fell, as did disbursements on project financing for the central Government and public corporations following restraint in investment programmes.

24. The capital account surplus further improved to SDR 294 million in 1990, as net central government inflows grew to almost SDR 270 million. This resulted from an SDR 56 million increase in concessional medium- and long-term disbursements mostly related to commodity and programme loans. Short-term borrowing by public corporations and private companies fell. No change was recorded in foreign direct investment, although it is expected that the liberalization of the foreign investment policy in 1990 will have positive effects on such flows in the future.

25. Sri Lanka's total external debt increased to SDR 3.6 billion in 1989. However, the ratio of total external debt to GDP dropped to 66.3 per cent from nearly 68 per cent in 1988. The share of concessional debt rose.

Similarly, the share of short-term debt increased as a result of Central Bank borrowing external reserves. The debt service ratio was down 5 percentage points, to 25 per cent, with significantly lower repayments due to the IMF.

26. In 1990, total external debt of Sri Lanka rose to SDR 3.7 billion, equivalent to 63.2 per cent of GDP. The share of concessional debt continued to increase. The share of short-term debt was stagnant while debt to multilateral creditors rose further to nearly 27 per cent of the total. The debt service ratio again improved to about 18 per cent, largely due to a reduction in interest payments on medium-and long-term debt and a fall in amortization of non-concessional borrowing.