DRAFT REPORT OF THE COMMITTEE ON BALANCE-OF-PAYMENTS RESTRICTIONS
ON THE CONSULTATION UNDER ARTICLE XVIII:12(a) WITH CEYLON

1. As instructed by the Council of representatives, the Committee has conducted a consultation, under paragraph 12(a) of Article XVIII, with the Government of Ceylon concerning the "substantial intensification" of balance-of-payments import restrictions which took place on 25 January 1961. The Committee took note of the minutes of the Council meeting held on 9 February 1961, at which the consultation had been initiated (C/M/3). In conducting the consultation the Committee had before it: (a) the text of the statement made by the representative of Ceylon at the meeting of the Council on 9 February 1961 (L/1419); (b) the Ceylon Government Gazette, Extraordinary No. 12,274 of 25 January 1961, which contains notifications and notices setting out the modifications in the import control system; and (c) documents provided by the International Monetary Fund as mentioned in paragraph 2 below. The consultation was completed on 24 February 1961. 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 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 paper containing background material on Ceylon dated February 2, 1961, and in addition a supplementary background paper dated February 16, 1961. It is possible that minor corrections will be made to the background material. If so they will of course be made available to the CONTRACTING PARTIES. At this time I should like to express the Fund's thanks to the authorities of Ceylon and also to the GATT secretariat for the provision of material which facilitated the Fund's preparation of the supplementary paper.

"Concerning the intensification of import restrictions now under consideration by the Committee, the general level of restrictions of Ceylon which are under reference does not go beyond the extent necessary at the present time to stop a serious decline in its monetary reserves."
"With respect to alternative corrective measures which may be available, the trend toward intensification of restrictions in Ceylon has arisen in large measure from internal inflationary pressures. The Government of Ceylon has undertaken and intends to undertake certain corrective fiscal and monetary measures. It is not clear, at this time, that these measures will be sufficient to deal with the situation."

Opening Statement by the Representative of Ceylon

3. In his opening statement, the full text of which is annexed to this report, the representative of Ceylon described the reasons which had compelled his Government to intensify import restrictions. He recalled that at the time of the last consultation with Ceylon in November 1960 the Ceylon representative had stated that in the last four years Ceylon's external reserves had fallen substantially, from Rs.1,179 million at the end of 1956 to Rs.555 million at the end of August 1960, and that the immediate prospect for an improvement in the balance of payments was not encouraging in view of the decline in prices of Ceylon's main export commodities. The expectation of the Ceylon Government at that time had therefore been that "import restrictions might have to be intensified in the near future in view of the rapid depletion of exchange reserves" (see L/1352).

4. The representative of Ceylon noted that the monetary, fiscal and import licensing measures which had been taken in August and September 1960 had unfortunately proved inadequate to stop a further decline in reserves. Provisional data showed that during the last quarter of 1960 Ceylon had incurred a deficit of Rs.76 million on current account, thus bringing the total current account deficit in 1960 to a record Rs.229 million. During the same quarter external reserves had fallen by Rs.48 million, thus bringing the total decline in reserves for the year to Rs.208 million. In January 1961 reserves had declined further to Rs.468 million by the end of that month. Excluding sinking funds, investments owned by semi-governmental savings banks and bilateral payments swing credits the level of external reserves at the end of January was equivalent to the value of less than one month's imports. Export earnings in 1960, thanks to good export prices for rubber prevailing in the early part of the year and the larger volume of tea exports, had been slightly higher than in 1959. The customary deficit on invisible account had been smaller in 1960 than in the previous year. The deterioration in the balance-of-payments position in 1960 had been primarily due to the continuing trend of rising merchandise imports.

1 All figures relating to the whole of 1960 used in this report are based on provisional data.
5. The favourable export earnings had not continued in the second half year. Between June and December 1960 the average export price of rubber had fallen by about 20 per cent and the average export prices of copra and coconut oil by about 19 per cent. In addition the export price of tea had been continually falling since 1955 and no reversal of the trend was in sight. By January 1961 it had become clear that further remedial action on a wide front was required to redress the situation arising from these falling prices. At the same time development efforts under the Ten Year Development Plan were expected to place additional strains on the reserves.

6. In these circumstances the Government had been obliged to introduce new monetary and fiscal measures in order to restrain the growth of domestic demand. At the same time import duties were raised for almost all imports, and import restrictions were intensified in order to provide immediate relief to the balance-of-payments situation. In the monetary field a special reserve ratio was imposed for all demand deposit obligations over the level standing at the end of January 1961, and the concessional Bank Rates, previously granted for certain types of commercial paper, were withdrawn. In the fiscal field, in addition to the increase in import duties, there was a reduction of 10 per cent in the Government expenditure budgeted for the fiscal year ending in September 1961. The Government had announced in September 1960 that it did not intend to engage in any inflationary financing during the year. One of the purposes of the recent increase in import duties was to compensate for the loss of export tax revenue so as to contain the budgetary deficit. In the absence of a broad revenue basis like a sales tax, the increase in customs duties, was also an important means for reducing inflationary pressures and for raising finance for the development programme.

7. The representative of Ceylon stated that had it not been for the tariff increases the intensification of import restrictions on balance-of-payments grounds would almost certainly have had to be more severe. Furthermore, an intensification of restrictions by itself, while giving relief to immediate balance-of-payments pressures, would have adversely affected Government revenue and would not have had a restraining influence on domestic demand. Quantitative restrictions had been intensified to provide immediate relief for the balance of payments while the other measures were exerting their effects on the national income and the demand for imports.

8. In conclusion the representative of Ceylon emphasized that while the further deterioration in Ceylon's reserve position had imperatively necessitated the tightening of import restrictions, this measure had not been resorted to without a parallel attempt being made to curb the domestic demand for imports.
9. Members of the Committee thanked the Ceylon representative for his clear and informative statement, and expressed awareness of and sympathy for the Government and people of Ceylon for the difficulties with which they were faced. They regretted, however, that the Government of Ceylon found it necessary to intensify restrictions rather than resorting to more effective internal measures to deal with these difficulties.

Balance-of-Payments Position and Prospects

10. In discussion of the balance-of-payments position and prospects members of the Committee enquired about the factors mainly responsible for the continuous deterioration of the balance of payments from 1957. The representative of Ceylon explained that the main factor responsible for the deterioration over the last four years had been the marked increases in merchandise imports, of both consumer and capital goods. The 33 per cent increase in import payment for capital equipment in 1959 over that of the previous year reflected a substantial increase in imports of transport and harbour equipment, following the nationalization of road transport and Colombo harbour. Preliminary trade statistics for 1960 indicated that total imports declined from Rs.2,005 million in 1959 to Rs.1,965 million in 1960. This decline was mainly in consumer goods, which were subjected to monetary, tariff and licensing restrictions in August 1960. Imports of capital goods had remained substantially at the high level reached in 1959. Export price fluctuations had on the whole been a less important factor in the deterioration of the balance of payments except in 1957/58 and the second half of 1960 when a substantial fall in the export prices of rubber, copra and coconut oil, had added significantly to the loss of foreign exchange reserves. As regards the foreign exchange earning prospects for Ceylon's major export commodities, the representative of Ceylon stated that there were no present indications of a recovery of the export prices. Rather it was felt that in 1961 Ceylon's export earnings would decrease below those realized in 1960. The reduction in export prices had not been accompanied by a reduction in average import prices.

11. In reply to a question concerning the regional distribution of the balance of payments, the representative of Ceylon explained that the deficit had been increasing in 1959 and 1960 vis-à-vis the sterling area, particularly with respect to India, Pakistan and the United Kingdom, and vis-à-vis the OEEC area. Ceylon's traditional surplus with the dollar area had been larger in 1960. Transactions with the rest of the world had shown a smaller deficit in 1960, mainly as a result of increased earnings from Middle Eastern countries and mainland China.
Alternative Measures to Restore Equilibrium

12. In discussing the fiscal and monetary measures taken by Ceylon, members of the Committee expressed appreciation for the readiness which had been shown by the Government of Ceylon in trying to reduce excessive import demand through the use of such internal measures. Some members of the Committee questioned whether the measures which had been taken were sufficient for curbing inflationary tendencies, especially as the restriction of the imports might simply lead to a concentration of demand on domestic goods and thus, increase the pressure on prices. Members of the Committee enquired to what extent the fiscal and monetary measures now in operation were expected to contribute to the reduction of excess purchasing power and what were the additional internal measures which the Government had indicated it was considering. The representative of Ceylon explained that the internal measures, the import restrictions and the tariff increases which had been adopted by his Government in dealing with the present situation had been considered by the Government to be the most suitable combination of corrective measures in the present circumstances. His Government was aware of the effects of import restrictions on the demand for domestic goods and on price stability. In order to prevent a mere shifting of demand the Government had adopted a series of fiscal measures which were expected to reduce the purchasing power of the general public. For example, the tax measures introduced in September 1960 were expected to yield additional revenue of approximately Rs.130 million this year. Similarly, the recent increase in tariffs was also expected to have the effect, inter alia of reducing excess purchasing power. For the same reasons the introduction of a sales tax was being actively considered by the Government, having regard to the desirability to restrain demand over as wide a range of goods as possible rather than primarily with respect to imports. No final decision had, however, so far been reached in this matter. In addition to these and other measures outlined above, the Government was also giving active consideration to the better utilization of foreign loans and grants to cover budgeted expenditures and to a more positive policy promoting savings.

13. Members of the Committee enquired about the Government's estimate of additional revenue to be derived from the recently introduced tariff increases. They noted in this context that many of the items showing the greatest tariff increases had also been made subject to quantitative restrictions. The representative of Ceylon explained that in view of the short time since the imposition of the higher duties and in view of the difficulty to assess beforehand the effect of tariff increases on the volume of imports no precise estimate had been formed of the amount of additional revenue resulting from these measures. While agreeing that total customs receipts from those imports which were subjected to quantitative restrictions were likely to be smaller than they would be in the
absence of such restrictions, he pointed out that higher tariffs were used in combination with import restrictions in order that, where the higher tariffs proved ineffective in curtailing imports to the required extent, the import licensing system would operate as the effective limit on imports. More important as a source of additional revenue was the general increase in customs duties by 5 per cent applying to all imports except food items; this increase was not expected to cause a substantial reduction in imports since it applied equally to a wide range of imports.

14. Noting that Ceylon depended for a large part of its external earnings on a few primary products, members of the Committee welcomed the prospect of a broadening of Ceylon's industrial base which, it was hoped, would result also in a widening of the range of goods available for export. They asked whether an indication could be given at this time of estimated export availabilities in coming years in accordance with export targets under the present Ten Year Plan and of the level of exchange reserves which would be required in coming years to ensure the successful implementation of the Plan. The representative of Ceylon confirmed that one of the important aims of the Development Plan was to reduce Ceylon's dependence for its foreign exchange earnings on a few primary products. The Plan was, however, not a rigid one and it was not possible therefore to indicate specific export targets or expected increases in export availabilities resulting from the implementation of the Plan. Also, in view of his Government's flexible approach to implementing the Development Plan no long-range estimates had been made so far for the allocation in coming years of foreign exchange for specific development projects. In reply to a question whether the balance-of-payments deficit which had been experienced by Ceylon in recent years might not indicate that the Ten Year Plan was over-ambitious in relation to the country's foreign exchange earning capacity, the representative of Ceylon explained that admittedly increased capital goods imports which had been a main factor responsible for the deterioration in the foreign reserve position, were an inevitable result of increased capital expenditure - both inside and outside the Plan. However, in drawing up and in implementing the Plan the Government had been and would be giving its full attention to estimated foreign exchange availabilities.

15. In discussing the rôle of private foreign investment in assisting economic development and in providing foreign exchange resources the representative of Ceylon stated that his Government was welcoming foreign investment in all fields other than a few reserved for the public sector. He referred to the statement made by the representative of Ceylon during the consultation in November 1960 (see L/1352) concerning the concessions and special incentives to foreign investors guaranteed by his Government, as outlined in the last budget speech of the Ceylon Minister of Finance.
Members of the Committee noted the favourable attitude of the Ceylon Government towards foreign investment. Some members expressed the view that the incentives and guarantees given by Ceylon to foreign investors would open increased investment opportunities and lead to increased capital imports, particularly once the Government had succeeded in checking the inflationary forces in the economy.

Systems and Methods of Restrictions

16. In the discussion of the measures taken by Ceylon on 25 January 1961, members of the Committee drew the attention of the representative of Ceylon to the hardships which might result for exporters, particularly with respect to items primarily designed for the Ceylon market, from the requirement that all outstanding orders should be cancelled immediately. They enquired what provisions had been made for a revalidation of import licences for orders placed prior to the coming into force of the new restrictions. The representative of Ceylon reassured the Committee that it was not intended to shut out imports of goods for which orders could not be cancelled without undue hardships for exporters and that provision had therefore been made for reviewing and, depending on the merits of the case, revalidating licences affected by these measures.

17. In reply to a question concerning the justification of the import prohibitions imposed on diamonds, soap, jaggery, and bicycle tyres and tubes, the representative of Ceylon explained that the ban on diamond imports had been decided upon in view of the necessity to restrict in present circumstances items of a luxury nature and the prohibition on jaggery was introduced on public health grounds, this product being the basic material used in the illegal distillation of arrack. With respect to the remaining items, import possibilities had been suspended because sufficient stocks of these items were available in the country.

18. As regards the threat of confiscation, mentioned in Import Control Notice No. 3/61, the Ceylon representative pointed out that this applied only to goods which had been ordered after the publication of this Notice. Members of the Committee, while in sympathy with the special considerations which had led to the prohibition of these imports, pointed out that in accordance with the provisions of paragraph 10 of Article XVIII, countries restricting imports for balance-of-payments reasons should endeavour, in the interest of maintaining established channels of trade, to permit the importation of at least token quantities of the restricted items. They expressed the hope that Ceylon would give effect to this requirement. The representative of Ceylon stated that his Government would keep this matter in mind when reviewing the import control measures.
19. In answer to a question concerning the effect of the intensification of restrictions on licensing procedures for goods previously subject to licence under the Industrial Products Act, the representative of Ceylon confirmed that the requirement under the Act for importers to purchase imported and domestic goods in a specified ratio had not been abolished by the introduction of individual licensing for these goods. In response to further specific questions relating to the implementation of the licensing controls the representative of Ceylon confirmed that the regulation concerning the "Ceylonization" of trade would also continue to apply in the case of newly restricted imports. He assured the Committee that import quotas, once established, would be made public.

**Effects of the Restrictions**

20. In reply to a question concerning possible adverse effects of the import restrictions on Ceylon's export industries, the representative of Ceylon stated that these restrictions were not likely to reduce export availabilities, most of the country's export commodities being agricultural primary products depending on no imported raw materials. The Government was also determined not to restrict unduly imports of capital equipment and development goods.

**General**

21. The Committee expressed appreciation for the readiness on the part of the Ceylon Government in bringing the case to the attention of the CONTRACTING PARTIES and in entering into the required consultation. It thanked the representative of Ceylon for the frank and helpful manner in which they had engaged in the consultation and expressed its sympathy for the difficulties with which Ceylon was faced. Members of the Committee expressed some regret, however, that Ceylon had been unable to avoid a substantial intensification of the import restrictions, especially since a number of other countries in the region had difficulties similar to those faced by Ceylon. The Ceylon Government should therefore keep well in mind the adverse effects of its restrictions on the export earnings of the neighbouring developing countries. Members of the Committee while welcoming the fiscal and monetary measures taken by Ceylon to counteract inflationary internal demand, expressed the hope that the protection of the balance of payments would in the near future increasingly be sought through the use of such internal measures and not through import restrictions.
22. The representative of Ceylon thanked the Committee for the understanding and sympathetic manner in which the consultation had been conducted. He assured the Committee that his Government would revert to its customary liberal import policy as soon as the balance-of-payments position permitted. In the meantime careful attention and consideration would be given by his Government to the many helpful suggestions which had been made by members of the Committee during the consultation concerning the implementation of the import control policy and other measures restraining inflationary import demand.
I propose to summarize briefly the economic and financial position in Ceylon as it was presented to the Committee on Balance of Payments at the time of the last consultations under Article XVIII:12(b) in November 1960 and then to describe in some detail the subsequent developments in the domestic and internal economic situation, using the latest statistical data available.

The statement of the Ceylon representative to the Committee on Balance of Payments in November 1960 and the Committee's report of the same date dealt in some detail with the domestic and external financial situation prevailing in Ceylon up to that time and focussed attention particularly on the monetary, tariff and import licensing measures introduced in August and September 1960, in order to stem the drain on Ceylon's external reserves. The dominant feature of Ceylon's external financial situation was the large and continuing balance-of-payments deficits beginning from 1957 which had caused a serious decline in the country's external reserves. The successive current account deficits in 1957, 1958, 1959 and the first half of 1960 had reduced Ceylon's external reserves from Rs.1,179 million at the end of 1956 to Rs.555 million at the end of August 1960.

The Ceylon representative's statement also pointed out that Ceylon's balance-of-payments prospects as they appeared at that time were not encouraging in view of the decline in the prices of Ceylon's main export commodities and indicated that "import restrictions might have to be intensified in the near future in view of the rapid depletion of exchange reserves".

On the domestic side it was pointed out that despite the sharp decline in external reserves domestic money supply had continued to increase. The contributory factors to the rise in money supply had been the large budget deficits as well as bank credit creation to the private sector.

The monetary, fiscal and import licensing measures of August and September 1960, which were described in detail by the Ceylon representative, were introduced in this background in order to meet the pressing balance-of-payments problem. I may point out that the Fund's opinion (as expressed in the course of the consultation with Ceylon under Article XVIII of the General Agreement in November 1960) of these August 1960 measures was that "while their full effect 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".

It is now however, clear that the measures taken in August and September 1960 have proved inadequate to stop the decline in reserves. Even during the last quarter of 1960, there was a deficit of Rs.78 million in the current account and a further fall of Rs.48 million in the external reserves. The cumulative current account deficit in 1960 has been Rs.229 million, which is
even higher than that in 1959. The deterioration in the balance of payments in 1960 has been entirely due to the continuing trend of increase in payments for merchandise imports. Export earnings in 1960, thanks to the good prices for rubber prevailing in the early part of the year and the increased volume of tea exports, were a little higher than in 1959 and the customary deficit on invisible account in 1960 was smaller than in 1959. The cumulative decline in external reserves in 1960 was Rs. 208 million or 30 per cent. There has been a further fall in reserves in January 1961, bringing down the level of external reserves to Rs. 468 million. Once sinking funds, trustee funds (e.g. investments owned by semi-governmental savings banks) and swing credits under the various payments agreements are excluded as not being immediately available to settle balance-of-payments deficits, the January 1961 level of external reserves is equal to less than one month's imports.

Moreover, it became increasingly evident by the end of 1960 that the prospects for rubber and coconut products had further deteriorated. Thus between June and December 1960, the average export price of rubber dropped by about 20 per cent and the average prices of copra and coconut oil declined by 19 per cent. The weakened export markets for these two products plus the trend of decline in tea export prices, which has been evident since 1955, was bound to have a significantly adverse effect on Ceylon's export earnings in 1961. In addition, with the Government's plan to intensify its development efforts under the Ten Year Development Programme, an additional strain was going to be imposed on the country's balance-of-payments.

For these reasons, it became abundantly clear by January 1961 that further remedial action on a wide front was required. This was the background to the new monetary, fiscal and import licensing measures taken in late January 1961. The monetary and fiscal measures were directed at restraining the growth of domestic demand for imports. The import licensing and tariff measures, on the other hand, were designed to have a direct restraining impact on imports and to provide immediate relief to the low external reserve position.

The main new monetary measure was the imposition of a special marginal reserve ratio of 38 per cent on any increase in banks' demand deposits from their end of January level, in addition to the general reserve ratio of 18 per cent on all demand deposits. Although the restrictive monetary measures of August 1960 had succeeded in curbing the growth of bank credit to the private sector, commercial banks continued to be in a highly liquid position. The special deposit reserve ratio was directed at reducing the excess liquidity of commercial banks. The second new monetary measure was the withdrawal of the concessionary Bank Rates which applied on Central Bank credit to commercial banks against certain types of paper (e.g. for export financing), making the higher rate of 4 per cent effective on all Central Bank credit to commercial banks.

The main fiscal measures were the increases in the import duties and a reduction of 10 per cent in the government recurrent expenditure budgeted for the current fiscal year, which ends in September 1961. The Government's budget deficit and the extent of its inflationary financing in the last fiscal year 1959/60, were practically at the same level as in the previous
year, 1958/59. In regard to the current fiscal year, the Government had announced in September 1960 that it did not intend to engage in any inflationary financing during the year. The fall in the prices of Ceylon's export commodities however, has compelled the Government to reduce its export duties. Thus the export duty on rubber has been successively reduced in November 1960 and in February 1961. The loss of revenue from export duties had to be offset in some manner if the Government's intention to avoid inflationary financing in the current fiscal year was to be achieved. This accounts in part for the recent increases in import duties. The tariff increases are justified on other grounds as well. Firstly, in a country engaged on a development programme the finance for development has to be drawn from as broad a base as possible. A familiar means is the sales tax. In Ceylon, in the absence of a sales tax, import duties have been used as a substitute. Secondly, the increased tariffs have the advantage of discouraging the demand for imports through higher domestic prices of imported goods, whilst simultaneously mopping up a part of the funds in the hands of the general public. A tightening of import restrictions alone would have caused a serious loss of Government revenue and also would have had the effect of reducing the flow of imports without doing anything to reduce the level of domestic demand.

The monetary and fiscal measures needed to be reinforced by an intensification of import restrictions for good reasons. The monetary and fiscal measures would by themselves have taken time to produce the urgently required relief to the balance-of-payments. It would also have been difficult to assess with any certainty their potential import reducing effect. Further, in view of their lagged effect on imports the magnitude of the restriction of bank credit to the Government and the private sector which would have been required to produce immediately a sizeable reduction in imports, would have been impractically large. Therefore, import restrictions had to be resorted to as a direct method of curtailing imports.

Higher import duties too directly restrain imports by increasing domestic prices of imported goods and it would be fair to say that, but for the increases in tariffs, the degree of quantitative restrictions on imports would have been higher. The use of the tariff system in combination with import licensing was resorted to in order that where the higher duties proved ineffective in curtailing imports to the required extent, the import licensing system would provide an effective limit on imports.

In concluding, I would like to emphasize that the recent intensification of import restrictions has not been resorted to without a parallel attempt to curb the domestic demand for imports. In its report at the time of the last consultations in November 1960, this Committee expressed the hope that in case the measures introduced in August and September 1960 "should turn out to be inadequate, the Ceylon authorities would explore other internal measures to restrain demand before resorting to import restrictions". As explained earlier the failure of the August and September 1960 measures to provide adequate relief to the balance-of-payments and the further deterioration in the external reserve position made it imperative that direct restrictions on imports be tightened immediately. However, it is significant that the Government also simultaneously took monetary and fiscal measures to restrain internal demand for imports.

Thank you, Mr. Chairman.