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Committee on Balance-of-Payments Restrictions

REPORT ON THE 1995 CONSULTATION WITH SRI LANKA

1. The WTO and the GATT 1947 Committees on Balance-of-Payments Restrictions consulted jointly with Sri Lanka on 2 and 3 November 1995. The consultation was held under the Chairmanship of Mr. P.Witt (Germany), in accordance with the Committees' terms of reference, pursuant to Article XVIII:B, paragraph 12 (a) of GATT 1994 and the Understanding on the Balance-of-Payments Provisions of GATT 1994. The International Monetary Fund was invited to participate in the consultation in accordance with Article XV:2 of GATT 1994.

2. The Committee had the following documents before it:

Basic document supplied by Sri Lanka

WT/BOP/8

BOP/326

Background paper by the Secretariat

WT/BOP/W/8

BOP/W/163

International Monetary Fund

Statistical Tables for Sri Lanka, dated May 2, 1995;
and Background Papers for Sri Lanka, dated May 10, 1995.

Opening Statement by the Representative of Sri Lanka

3. The opening statement of the representative of Sri Lanka is attached as Annex I.

Statement by the Representative of the International Monetary Fund

4. The statement made by the representative of the International Monetary Fund is attached as Annex II.

Discussion in the Committees

(i) Balance-of-payments position and prospects; alternative measures to restore equilibrium

5. Members commended the government of Sri Lanka for the economic reforms pursued since 1989, including the liberalization of the trade régime, despite the difficult domestic conditions under which the economy operated. The reform process had led to accelerated growth; Sri Lanka's share in world trade had increased and its ratio of debt service to exports of goods and services had fallen. However, the annual rate of inflation remained at around 10 per cent in 1995. Members took note that Sri Lanka had accepted the obligations of Article VIII of the IMF Articles of Agreement.

6. Some Members observed that, notwithstanding the apparent stability of Sri Lanka's balance-of-payments, it continued to be structurally weak: exports were concentrated in a few items and the

sustained high demand continued to exert pressure on the trade account. The current account deficit at 8 per cent of GDP in 1994 was high compared to the generally prescribed limit of 3 to 4 per cent; within this, a major element was a surplus on invisibles, mainly composed of workers' remittances, which were liable to wide fluctuations and dependant on developments abroad. The rise in gross official reserves had its source mainly in various short-term capital elements which were potentially volatile. Foreign capital inflows had slowed down in the recent past. Uncertain conditions faced by the Sri Lankan economy, in a difficult national security situation, had been an additional factor that adversely affected the balance of payments. Based on these considerations and against the background of Sri Lanka's efforts to liberalize its economy, these Members suggested that Sri Lanka had no continuing need for use of the balance-of-payments exception.

7. Other Members recognized that the current account deficit had increased in 1994 and that the high level of foreign debt continued to burden Sri Lanka's external position. However, the positive impact of reforms on the economy and the strong growth performance had attracted substantial inflows of private capital, resulting in a much more favourable external balance. There had been a relatively steady increase in gross official reserves from 1989 to 1994, stabilizing at around five months of import coverage in the past three years. Also the debt-service ratio had continued to decline since 1991. Some other Members noted the concerns about the sustainability of Sri Lanka's favourable external account and possible fluctuations in reserve levels because of the relative dependence on foreign aid and workers' remittances. Nevertheless, Members considered that the balance-of-payments situation of Sri Lanka was currently not in crisis. There was no threat of serious decline in monetary reserves or an inadequate level of monetary reserves as foreseen by Article XVIII:B. Therefore Sri Lanka's import restrictions could not be justified under the balance-of-payments exception.

8. These Members also stated that the improvement of the balance-of-payments on a sound and lasting basis required the adoption of appropriate macroeconomic policies, primarily fiscal consolidation but also monetary measures. According to the IMF, in 1994 the government deficit was in the order of 9.7 per cent of GDP. Trade measures distorted resource allocation in the economy and were not an appropriate means for responding to any concerns related to Sri Lanka's balance-of-payments position.

9. The representative of Sri Lanka concurred with the IMF staff's view, supported by Members, that macroeconomic imbalances were the source of balance-of-payments problems. The long-term solution to Sri Lanka's balance-of-payments problems lay in macroeconomic stability and prudent fiscal policies.

(ii) System, methods and effects of import restrictions

10. Members supported the steps that Sri Lanka had taken to liberalize most of the restrictions maintained for balance-of-payments reasons. Currently, restrictions on about 200 items were maintained solely for national security, public health, public moral and environmental consideration. According to the introductory statement by Sri Lanka, all such restrictions were consistent with the GATT 1994 Articles XX and XXI on General and Security Exceptions. Members, however, questioned the justification of the remaining quantitative restrictions on food items under eight HS tariff lines (WT/BOP/W/8, Table1) on balance-of-payments grounds. The continuation of such restrictions contrasted to the Government's efforts to bring transparency to Sri Lanka's trade régime.

11. Without prejudice to their views as to whether balance-of-payments situation in Sri Lanka warranted the use of Article XVIII:B, these Members observed that the measures Sri Lanka sought to justify did not meet the specific conditions of the Understanding on the Balance-of-Payments Provisions

of GATT 1994: The measures were not "price-based" (paragraph 3 of the Understanding) and were not applied to control the general level of imports (paragraph 4).

12. For Members, to the extent that restrictions targeted a narrow range of selected agricultural imports, their removal would not have any significant impact on the overall balance-of-payments position. Agricultural products represented a declining share of overall imports, standing at 18 per cent at end-1994. Given that Sri Lanka had bound a small percentage of industrial tariff lines, there was still scope for using price-based measures without recourse to Article XVIII:B. Members also noted that non-automatic discretionary import licensing was monitored by the Controller of Imports and Exports and that allocation of licences to importers of food items based on their previous performance meant that all rents accrued to established traders.

13. In response, the representative of Sri Lanka stated that his authorities chose to use quantitative restrictions, rather than price-based measures, because the storage of the twice yearly crop over long periods had distortionary effects on the market. Import licensing was a more effective means of controlling essential imports and thus had a positive impact on balance-of-payments position.

14. Concerning specific items, the Sri Lankan authorities acknowledged that four HS lines, covering potatoes, onions and pepper, were restricted primarily to protect a large number of domestic producers in rural areas, until such time these local farmers developed improved farming techniques and became competitive. The civil conflict affecting Sri Lanka had prevented the development of such agriculture. Taking note of this explanation, Members found no basis for the relationship between the protection of farmers under civil conflict conditions and the restrictions maintained on imports of a few selected products for balance-of-payments purposes. They considered that the Security Exceptions of GATT 1994 Article XXI could provide the appropriate alternative legal coverage for these restrictions.

15. Concerning restrictions on wheat, meslin, and wheat and meslin flour, Members took note of the statement by the representative of Sri Lanka (WT/BOP/8, paragraph 26) that import licensing was required under of a long-term contract between the Sri Lankan Government and a flour mill. In their view, such quantitative restrictions were also not related to balance-of-payments problems. In their view this licensing procedure was not a balance-of-payments measure; it could more appropriately be seen as a State-trading programme.

16. The representative of Sri Lanka explained that under an agreement concluded with a multinational firm, the Government had undertaken to supply a minimum quantity of wheat per month, Sri Lanka did not produce wheat; imports were from the United States under PL 480 program and the EEP under certain credit facilities. The major part of import and wholesale trade was handled by a state agency, the Cooperative Wholesale Establishment, for the purpose of monitoring foreign exchange payments and as part of an overall government programme on poverty alleviation.

17. Responding to comments on the impact of the measures on the improvement of the external imbalance, the representative of Sri Lanka stated that the restricted items were essential products. The economic objective of the restrictions was to have a positive impact on the balance of payments in the short-term. His authorities saw no need to justify the measures maintained for balance of payments reasons on other grounds. Sri Lanka would disinvoke Article XVIII:B when it considered that there was no longer need for such restrictions.

18. Members emphasized that the exceptions sought under the balance-of-payments provisions should be temporary. Sri Lanka's balance-of-payments position did not warrant the justification of restrictions under Article XVIII:B; the motivation for the few remaining restrictions did not seem to lie in any

balance-of-payments problem. While noting the Government's assertion of contractual obligations and other legitimate national security objectives, they failed to see how those measures could be justified on balance-of-payments grounds in terms of Article XVII:B.

19. The representative of Sri Lanka stated that the balance-of-payments situation had recently deteriorated and prospects for the rest of 1995 and 1996 were uncertain. His authorities were not in a position to disinvoke Article XVII:B. The measures were intended to be used on a temporary basis; however, Sri Lanka needed time for balance-of-payments to improve before they could eliminate all protective measures. Answering questions on a time-frame for the phase out of the the restrictions, the representative of Sri Lanka stated that the measures would be continued as long as they were warranted by the balance-of-payments situation.

20. Members considered that the reasons for maintaining the restrictions was not related to Sri Lanka's balance-of-reasons situation. The continuation of the restrictions would not contribute to sustainable balance-of-payments. In line with the recent liberalization efforts, they asserted that Sri Lanka should cease to maintain restrictions for balance-of-payments reasons.

Conclusions

21. The Committees congratulated Sri Lanka on the reforms towards open, liberal and market-oriented economic and trade policies undertaken in recent years, including tariff rationalization and a major reduction in the scope of import licensing. These reforms had contributed to strong economic performance, despite the negative effects of the civil conflict in the north and east of the country.

22. The deterioration in the economic situation since mid-1994, rooted in a growing fiscal deficit and rapid credit expansion, had a negative impact on the balance of payments. Nevertheless, international reserves remained around five months of imports of goods and services, and most members did not perceive a threat of a serious decline in Sri Lanka's international reserves as set out in paragraph 9 of Article XVIII, nor a critical balance-of-payments situation as set out in paragraph 3 of the Understanding. Some members pointed to uncertainties inherent in the structure of the current account and the high level of indebtedness.

23. The Committees recalled that restrictive measures for balance-of-payments purposes should be temporary, price-based, administered in a transparent manner and applied only to control the general level of imports.

24. The Committees noted that in the case of four products for which Sri Lanka continued to invoke balance-of-payments provisions (HS items 0701.90; 0703.10.01; 0703.10.02; 0904.20), import restrictions, initially enforced to safeguard the interests of farmers, were retained because of the civil conflict. The Committees took note of the statement by Sri Lanka that, were it not for this situation, protection by import licensing would not be necessary.

25. The Committees also noted that import licensing on four other products (HS items 1001.10; 1001.90; 1101.00; 1103.11) was maintained in the context of State-purchasing arrangements for imports of grain on concessional terms, to be milled by a private company under a long-term Government contract.

26. The Committees considered that, even if a balance-of-payments problem existed, given the limited impact of the import licensing measures on agricultural imports in general and on the trade balance as a whole, such measures would not resolve such a problem.

27. On the basis of the above considerations, and in the light of all relevant provisions of GATT 1994, the Committees recommended to Sri Lanka not to have recourse to the provisions of Article XVIII:B.

ANNEX 1

Opening Statement by the Representative of Sri Lanka

In the first place, let me take this opportunity to express our sincere thanks to the WTO Secretariat for the extremely useful background paper prepared for today's consultations, and also to the IMF for releasing their valuable technical papers. Please also accept, Mr. Chairman, Delegates and Observers, our heartfelt thanks for your presence here today to participate at these deliberations.

As you are all aware we conducted the last balance-of-payments Consultation (simplified procedures) in July 1994. Our written statement, already distributed, sets out in greater detail, the developments in overall trade, tariff and exchange policies in Sri Lanka since the last consultation, as well as further concrete liberalization measures in these spheres with a view to vigorously carrying forward the process of open liberal and market-friendly economic and trade policies. The steady deterioration in Sri Lanka's balance-of-payments situation and the imperative need to continue to invoke Article XVIII:B of GATT for supporting Sri Lanka's external financial position have also been elucidated in the paper distributed today.

Sri Lanka has continued with liberalized market-friendly trade policies since 1977 and significant progress has been made towards competitive trading environment, especially during the past few years, reducing quantitative restrictions on both imports and exports, rationalizing and simplifying the tariff structure to a three band band system eliminating state monopoly on economic activities, shifting towards a flexibly managed exchange rates system, relaxation of exchange control regulations, finally removing all restrictions on payments for current account transactions and eventually accepting Article VIII status of the IMF Articles of Agreement were among the major achievements recorded in the continued process of trade liberalization.

Mr. Chairman, it would be clearly observed the net logical outcome of the continuation of these open, liberal and market-friendly trade and exchange policies has been the virtual dismantling of the restrictive import licensing control, with only the bare minimum of such measures being retained solely for national security, public health, public moral and environmental consideration. All these remaining import licensing controls are fully in conformity with and justifiable under GATT Articles XX and XXI on general and special exemptions.

It is significant to note that Sri Lanka has continued on its path towards trade and economy liberalization, while completely adhering to the norms of conduct in the rule-based multilateral trading system as embodied in the GATT/WTO. Throughout its membership both in the GATT and the WTO as founding members, Sri Lanka never had any recourse whatsoever to emergency safeguards measures provided in GATT Article XIX or anti-dumping provisions. Nevertheless, we have continued to invoke the Article XVIII:B of GATT since 1971 for balance-of-payments considerations in order to support our external financial position.

As will be clearly observed from recent trends, since the last consultation as indicated in our paper, what is the harsh reality in the balance-of-payments situation in Sri Lanka, which legitimately warrant the continuation of the invocation of GATT Article XVIII:B? Mr. Chairman, it is nothing but one of sharp reduction in the overall surplus in 1994 as compared to that in 1993 and a subsequent steady deterioration registering a deficit on the basis of latest figures for August 1995. Therefore, these adverse trends in our balance-of-payments situation cannot be at all described as a strong and healthy balance-of-payments position for Sri Lanka.

It could be observed from the Table 1 of Annex A of our paper that the widening gap between exports and imports has been offset by a substantial inflow of remittances by Sri Lankans employed abroad and capital inflows such as foreign grants, foreign loans, foreign direct investments and portfolio investments. These developments in the balance-of-payments turned the overall balance into a surplus. However, this situation does not represent a strong balance-of-payments position as they are either contingency liabilities or they may flow outward as easily as they did inward. Relying on a balance-of-payments surplus on the basis of capital transfers of this nature may prove a destabilizing factor in our economy. As a matter of fact, the latest indications suggest that sharp decline in the overall balance from SDR 375 million in 1993 to SDR 173 million in 1994 has continued and hence the overall balance has turned into a deficit of SDR 42 million during the first eight months of 1995. Exports grew by 12.5 per cent as compared with 11.2 per cent in the corresponding period of the previous year while imports increased by 7.8 per cent as compared with 7.6 per cent in the corresponding period of the previous year. The gross external assets at the end of August 1995 were sufficient to finance 5.5 months of import projected for 1995 while the import capacity of external assets were at 6.2 months as at the end August, 1994. The current indications are that the overall balance of payment would be in deficit for the year of 1995 as a whole.

Another factor which has adversely impacted on the balance-of-payments situation is the unsettled situation in the North and East of Sri Lanka. the ongoing war in the country and the heavy expenditure involved towards meeting the cost of war has been a heavy burden on the economy over the years. According to the latest estimates, Sri Lanka's defence expenditure would increase to SDR 402 million in 1995 representing 9 per cent of GDP which is 1.5 per cent higher than the original estimate. The recent tragedy in the oil storage facility with an estimated loss of around SDR 20 million has aggravated this situation. Under the circumstances, Sri Lanka has to utilize its foreign reserves or to depend heavily on foreign assistance which would further deteriorate the balance-of-payments position.

Mr. Chairman, needless to highlight the common phenomenon that the balance-of-payments situation in Sri Lanka, as in many other developing nations, does only partially fall within the full control of prudently executed liberal trade and exchange policies per se, with the vagaries of fluctuating world market prices of export and import commodities and also violent and sharp gyrations of the values of reserve currencies playing a pivotal role. In this connection, better and improved market access coupled with sufficiently remunerative price levels for our export commodities in the international market place and also reasonably stable prices for our imports will contribute in a big way towards further improvement of our balance-of-payments situation in the future.

Mr. Chairman, it is clearly evident from the above analysis of adverse factors governing the deterioration of balance-of-payments situation in Sri Lanka and prospects for its continuation in the near future and also due to the extremely volatile and unstable nature of determinants of the balance-of-payments situation such as portfolio investments and worker remittances from abroad, Sri Lanka is left with no other viable option but to continue to invoke GATT Article XVIII:B, thereby keeping in place the import licensing measures, which we notified consequent on last consultation in respect of potatoes, onions, chillies, wheat, meslin and wheat and meslin and flour. These import licensing measures will continue to remain as long as they are warranted by the need to protect the balance-of-payments situation. Nevertheless, Sri Lanka will continue to objectively review these licensing measures against the background of concrete developments in the balance-of-payments situation in the future.

In conclusions, Mr Chairman, it is our fervent hope that this Committee will full endorse the Sri Lankan position favouring the continuation of invocation of GATT Article XVIII:B for supporting our external financial situation.

ANNEX 2

Statement by the IMF Representative

Since the late 1980s, Sri Lanka has been laying the foundation for sustained economic growth within a more open and market-based environment. The prospects for improved financial stability and better security conditions in most of the country created a favorable investment climate that contributed to reasonable growth and a strong external position. Nevertheless, the country failed to achieve the transition to a sustained high-growth/low-inflation path. A weak tax base and an inelastic tax system, together with an inefficient and oversized public sector, limited fiscal consolidation. Moreover, despite some progress, private sector growth and investment continued to be adversely affected by high borrowing costs and a segmented labor market.

More recently, since mid-1994, economic performance has been adversely affected by policy slippages associated with political events. Both the previous and current Governments implemented costly social measures around the time of parliamentary elections in 1994, including duty waivers and reductions in bread and kerosene prices. These actions resulted in a substantial widening of the fiscal deficit and a progressive weakening of the economic situation, which was further exacerbated by the full-scale resumption of the civil conflict in April 1995.

Developments in the balance of payments reflect the deterioration in the economic situation, which has its roots in a large fiscal deficit and rapid credit expansion. Up until late 1994, Sri Lanka had experienced unprecedented foreign inflows, including sizeable concessional aid flows, large remittances from overseas workers, and foreign direct and portfolio investment. These inflows led to balance of payments surpluses and allowed a significant increase in gross official reserves to about 5 months of imports. However, after weakening significantly in the final half of 1994, the overall balance shifted to a deficit in the first seven months of 1995. This shift reflected both a large current account deficit and a slowing of private capital inflows, resulting in a modest loss of reserves, to SDR 1.3 billion (4½ months of imports). The external current account balance has been particularly affected by the slippage in financial policies, deteriorating from a deficit of about 5 per cent of GDP (excluding official transfers) in 1993 to a deficit of over 7 per cent of GDP currently.

On the trade front, both import and export volumes have increased rapidly in recent years. The particularly fast growth of imports also resulted from tariff cuts and a reduction in the scope of import licensing restrictions as well as from loose financial policies. Export performance has been strong in nontraditional sectors, particularly garments and textiles; traditional export volumes--tea, rubber, and coconuts--have also recovered in recent years from the drought-induced decline in 1992. Thus far in 1995, imports and exports continue to be buoyant.

With regard to the exchange rate, the authorities have tended to depreciate the rupee gradually against the U.S. dollar by the amount of the effective inflation differential. The upsurge in inflation in recent months prompted a 4-5 per cent depreciation of the rupee/dollar rate since end-May. However, with the recent rise in the dollar vis-a-vis the yen, the rupee appreciated significantly in real effective terms. The real effective exchange rate is currently at a level similar to that of early 1993.

Real GDP growth surged to 7 per cent in 1993 in response to rapid expansion of manufacturing output and a strong recovery in agriculture. Output expansion slowed in late 1994 but still averaged

5½ per cent owing to a good harvest. For 1995, the authorities are projecting growth of about 5½ per cent but there are some signs of a slowing of economic activity.

Inflation has persisted at double digit levels in a climate of generally loose monetary and credit policies. While average annual inflation as measured by the official price index declined to 8½ per cent in 1994, the drop resulted from the reduction of duties through waivers and from cuts in government administered prices; excluding the impact of these cuts, consumer prices rose by 11½ per cent in 1994. Inflationary pressures have persisted in 1995, with consumer prices rising at a 12-month rate of about 11 per cent.

Sri Lanka's fiscal situation continues to be the major policy concern. After two years of fiscal consolidation, the budget position deteriorated significantly in 1994. The overall fiscal deficit (excluding grants) in 1994 increased to 10 per cent of GDP, compared with 8 per cent in 1993, largely reflecting a reduction in the tax base and expenditure overruns associated with the social measures and lax control over other expenditures. The deficit on current operations, which declined to less than 1 per cent of GDP in 1992 and 1993, jumped to 3 per cent of GDP in 1994. Pressures on current expenditures from the security situation continued throughout the period, with defense spending rising from 3 per cent of GDP in 1990 to 4 ¾ per cent of GDP in 1994.

The resumption of hostilities in April 1995 has put further pressure on an already precarious budgetary situation. A full-year deficit of 9½ per cent of GDP is projected for 1995, well in excess of the budgeted 7½ per cent. The main sources of slippage, beside markedly higher defense costs, are some revenue shortfalls; additional hiring and pay increases affecting the civil service wage bill; increased interest payments; and higher world wheat prices raising subsidy costs. Measures taken in June to offset the defense increase were only partly successful. The increasing fiscal pressures led to a sharp rise in short-term interest rates--3-month treasury bill yields have increased from 14 per cent to 20 per cent. Recognizing the need to contain the pressures, in September the Government began a gradual phaseout of bread subsidies, and has thus far raised the flour price 30 per cent. The debt/GDP ratio remains high at about 95 per cent, although external debt service is manageable because of the concessional nature of aid flows.

In the area of structural reform, while some progress has been made, significant structural impediments continue to constrain growth and economic efficiency. Tax and financial sector reforms, which have been long overdue, are just now being put in place with the introduction of a value-added tax and amendments to financial legislation. Progress toward liberalizing and simplifying the trade and tariff system since the early 1990s has been substantial, with a reduction from 19 bands to three, of 10, 20, and 35 per cent, and the elimination of a large number of import licensing restrictions. Sri Lanka also accepted the obligations of Article VIII in March 1994. However, there remain several discretionary exemptions, and a number of agricultural commodities continue to be subject to import licensing restrictions for balance of payments reasons.

External prospects are uncertain for the remainder of 1995 and 1996. A sustained narrowing of the current account deficit will require continued export growth and a tightening of financial policies, particularly fiscal consolidation, to keep import demand in check. Early cessation of the current hostilities would also contribute by limiting imports of military hardware. Foreign direct and portfolio investment will only pick up with the return of private sector confidence. Key to such an outcome would be an acceleration of the privatization program which, in addition to generating substantial capital inflows itself, would revive foreign interest in the stock exchange.

In conclusion, achievement of Sri Lanka's long-term objective of poverty elimination through high levels of sustainable growth will depend on structural improvements and macroeconomic stability. The recent deterioration in the balance of payments will be arrested on an enduring basis only by a substantial strengthening of the public finances. In this regard, licensing restrictions on selected agricultural products will do little to correct the fundamental macroeconomic imbalances, while distorting resource allocation. Developments thus far in 1995 suggest that progress toward Sri Lanka's long-term objectives will be delayed. For 1996, the authorities need to take steps to formulate a budget and to frame a complementary monetary policy, that could accompany an aggressive program of structural reform, including the timely elimination of the remaining import licensing restrictions.