India-Sri Lanka Bilateral FTA: Sri Lankan Perspective on Emerging Issues

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Introduction

Economic relations between India and Sri Lanka, which date back to pre-colonial times and began to pickup in the 1990s, received their biggest boost in 1998 when the two countries signed a bilateral Indo-Lanka Free Trade Agreement (ILFTA) which began implementation in March 2000. This was a pioneering attempt in the direction of trade liberalization in the South Asian region and involved the liberalization of trade in goods. Sri Lanka's economic objectives were to increase trade ties with South Asia's dominant economic power, to induce the transformation of Sri Lanka's exports from low-value added goods to high value-added goods aimed at niche markets and to provide low-income groups with cheap consumer imports from India (Kelegama 1999). The ILFTA was formulated based on the "negative list" approach; each country extending concessions/preferences to all commodities except those indicated in its negative list.[1] The two countries agreed for preferential treatment on 5112 tariff lines. Taking into account the asymmetry between the two countries, Sri Lanka was accorded special and differential treatment.[2] Rules of origin (ROO) criteria were also relaxed in Sri Lanka's favour.

Experience of the ILFTA: Recent Trends

Trade

Sri Lanka's trade with India changed dramatically following the implementation of the FTA. In the period 1995-2000 immediately preceding the agreement, average annual exports from Sri Lanka to India were US$ 39 million while average imports were US$ 509 million. While

[1] Sri Lanka's negative list comprises mainly agricultural products, key revenue items such as motor vehicles and items of significant domestic production such as ceramics and footwear.

[2] The immediate duty-free list (319 items) and 50% preferential duty list (889 items) were considerably smaller than those offered by India (1351 items and 2799 items respectively), while the Sri Lankan negative list (1180 items) was considerably lager than India's (196 items) (Kelegama and Mukherji 2007).

India was an important source of imports even prior to the Agreement, it was not a major export market, and in 2000 it ranked 14th in terms of export destinations (Kelegama and Mukherji 2007). By 2005, Sri Lanka's exports to India reached a peak of US$ 566.4, a tenfold increase compared to 2000, and stood at US$ 418.3 million in 2008. India was the fifth largest destination for Sri Lanka's exports in 2008 (Central Bank 2008). The number of products exported by Sri Lanka to India also increased substantially during this time. In 1999 Sri Lanka exported 505 tariff lines to India, whereas by 2005 this figure had increased to 1062 (de Mel 2009). Sri Lanka also began to export higher value-added products as the FTA progressed. In 1999 Sri Lanka's main exports to India included pepper, waste and scarp steel, areca nuts, dried fruit, cloves and waste paper. By 2008, there were still a number of primary products exported to India; however several value-added products such as insulated wires and cables, pneumatic tires, ceramics, vegetable fats and oils, refined copper products and furniture were among the top exports to India (Dept of Commerce). Imports too have grown at a rapid rate following the implementation of the FTA. Imports from India which amounted to US$ 600.1 million in 2000 reached US$ 3443 billion in 2008, a growth by 5.7 fold). India has been Sri Lanka's main source of imports since 1997.

An aggregate view of trade between India and Sri Lanka since the FTA came into being suggests a very positive picture with overall trade growing close to six fold and exports from Sri Lanka growing ten fold. Furthermore, the increased diversity and greater value addition in exports from Sri Lanka is a positive development. However, a more disaggregated analysis suggests that the trade and economic impacts of the Agreement have not been as encouraging as the aggregate data suggests. Although exports from Sri Lanka to India peaked at US$ 566.4 million in 2005, these exports were largely concentrated in two products – copper and vanaspathi – 49.66% of Sri Lanka's export value was from the export of these two tariff lines (Kelegama and Mukherji 2007). If vanaspathi and copper were excluded from the trade figures, Sri Lanka's exports to India would have increased from US$ 58 million in 2000 to just US$ 278 million in 2006, an increase of five fold compared to the ten fold increase with

vanaspathi and copper. It is thus clear that the narrowing of the trade deficit between the two countries was largely due to these two products.

The problem with vanaspathi and copper is that the rise in exports of these items was not due to any distinct comparative advantage that Sri Lanka held, but rather due to short-term tariff arbitration by Indian manufacturers investing in Sri Lanka.[3] The viability of the vanaspathi industry was only as long as there was a difference between the Indian and Sri Lankan tariffs on palm oil exports. In response to the increase in global commodity prices in 2007/2008, India cut import taxes on various food imports including palm oil, making vanaspathi exports from Sri Lanka unviable. Unsurprisingly, vanaspathi exports in 2008 were LKR 4.5 billion, a fall of 72% from exports in 2007 which amounted to LKR 16 billion. Vanaspathi exports are expected to be non-existent in 2009.

Copper exports from Sri Lanka were also subject to much scrutiny from India, based on their low domestic value addition, arguing that copper exports from Sri Lanka were under-invoiced. India insisted that pricing should be done based on the London Metal Exchange Prices, and since then a large proportion of Sri Lankan copper exports were deemed ineligible (IPS 2008). With the change in invoicing measures, copper exports from Sri Lanka was the first to be affected, with exports falling from US$ 145 million in 2005 to US$ 13 million in 2008 (Sri Lanka Customs). With the collapse of vanaspathi and copper exports in 2008, Sri Lanka's total exports to India in 2008 declined substantially to US$ 418 million, the lowest since 2004 (US$ 391 million) and a 26% fall in export value since the peak in 2005.

At the same time, imports from India have increased considerably in recent years. In 2008, imports from India reached a peak of US$ 3443 billion, a growth of 37% compared to 2007.

[3] India maintained high tariffs on imports of crude palm oil from countries such as Malaysia, while Sri Lanka maintained relatively low tariffs on imports of these products. Thus Indian manufacturers set up vanaspathi manufacturing plants in Sri Lanka, imported crude palm oil, processed it in Sri Lanka to form vanaspathi and exported it to India free of duty under the FTA.

However, the major cause for the increase in imports was the increased cost of petroleum products in global markets.[4] The import of petroleum products from India is not influenced by the FTA as petroleum imports are in Sri Lanka's negative list. In fact, the bulk of Indian imports into Sri Lanka (petroleum, vehicles, sugar, cotton, iron and steel, pharmaceutical products) are not subject to reduced tariff through the FTA as over 65% of Sri Lanka's import value from India is from products that are either in the negative list or are exempt from MFN duty. According to the Department of Commerce, Sri Lanka's imports under the FTA were only about 14% of the country's total imports from India in 2007.

These observations suggest that the growth of the trade deficit between India and Sri Lanka is not largely a result of the FTA between the two countries, since most of the major traded items are not subject to the FTA. Normal trade patterns between the two countries are likely to have resulted in an even wider trade deficit since the FTA has provided some scope for Sri Lankan exports to India. While, in general, exports to India have been skewed with the dominance of vanaspathi and copper, there has been rapid growth in exports of a few other products, such as rubber and articles thereof, articles of stone, plaster cement, furniture and apparel, which have been able to capture niches in the Indian market (Sri Lanka Customs). Also, a country need not be overly concerned about bilateral trade deficits. Given the nature of globalization and international division of labour, it is impossible to maintain trade surpluses with all trading partners, and these are simply a reflection of the industrial specialization that is associated with trading economies. Sri Lanka imports largely from countries such as India and China (and has large trade deficits with these countries) and exports to Europe and the US (and has large trade surpluses with these countries). Even if the trade deficit has expanded in the current account, this has been largely balanced by investment flows from India to Sri Lanka on the capital account.

[4] Crude oil reached US$ 148 a barrel in June 2008 (de Mel 2009).

Investment

Indian investment into Sri Lanka has also increased substantially since the FTA came into operation. Cumulative Indian investment which was a mere Rs 165 million in 1998 increased to US$ 125.925 million by 2008, contributing to 14% of total FDI flows to Sri Lanka (BOI 2008). India is now the second biggest investor in the country, exceeded only by Malaysia. The bulk of Indian investment (63%) in Sri Lanka in recent years has been in the services sector, being focused in sectors such as telecommunications (Bharthi Airtel), health (Apollo Hospitals), retail services (Lanka India Oil Company), energy, hospitality (Taj Hotels) and air transport services (Jet Airways).

However, much of the investment that came into Sri Lanka was associated with products such as vanaspathi and copper, as foreign investors from India and third parties saw an opportunity to break into India's market through Sri Lanka. Employment creation was also limited. According to the BOI, 5900 jobs were created as a result of Indian investment. But this includes 1500 employees in the Indian Oil Company retail outlets, which entailed re-hiring staff from the Ceylon Petroleum Corporation-owned outlets rather than creation of new jobs (de Mel 2008).

While the dominance of services suggests that the impact of the FTA (which only deals with trade in goods) on the investment decision (Indian firms investing in Sri Lanka to take advantage of the FTA to export products to India) is limited, it could be argued that the surge of investment between 2000 and 2008 was influenced by the increased profile of economic ties between the two countries and increased investor confidence as a result of the FTA.

Services

Monetary measurement of trade in services is very limited (due to the intangible nature of services) and therefore exact figures of trade in services are difficult to calculate. However, the extent of commercial services exchange between the two countries has increased as

demonstrated by the following examples. Many Sri Lankan students and patients travel to India to purchase education and health services each year, approximately 70% of the Colombo port's income is from transshipment earnings from India, approximately 40% of Sri Lanka airlines' revenue is from the Indian market while Indian airliners, Jetwing and Kingfisher have operations in Sri Lanka. Sri Lankan information technology firms have provided technical solutions to Indian companies and Sri Lankan tourist sector firms such as Aitken Spence and Jetwing have also ventured into the Indian market. India has become the largest source of tourists to Sri Lanka. During 2002-2007 tourist arrivals from India grew rapidly at 20.9% per annum, and accounted for 19.4% of the market share in 2008 (Sri Lanka Tourism Development Authority). Improved bilateral relations, including unilateral visa liberalization by Sri Lanka contributed to the rapid growth of Indian arrivals.

While the aggregate figures resulting from the ILFTA are impressive, the results have not been entirely positive from a Sri Lankan perspective. The key question, in terms of moving forward and lessons for the future, is: why hasn't there been a greater positive impact on the Sri Lankan economy as a result of the ILFTA? Several reasons have been identified.

- Tariff rate quotas on major exports

Tea, garments and textiles, which make up 58% of Sri Lanka's total exports, have been placed under quotas in the ILFTA. Also, quota utilization has been minimal due to stringent ROO requirements and port restrictions. Quota utilization has somewhat improved at present following a degree of relaxation of ROO and port restrictions in 2007.[5]

- Non-tariff barriers

Many Sri Lankan exporters have faced difficulties in entering the Indian market due to the maintenance of non-tariff barriers (NTBs) such as state taxes, quality requirements and

[5] India removed the port restrictions on tea imports from Sri Lanka within a quota of 12.5 million kg, and three million garment pieces now enjoy duty-free access to India (de Mel 2008a).

administrative procedures, which are outside the scope of tariff reduction under the FTA. One example is state taxes charged by Tamil Nadu, where Sri Lankan exporters are taxed at 21% while local products are taxed at 10.5% on sales (Kelegama and Mukherji 2007).

- Rules of origin

Besides the stringent ROO within the tariff rate quotas (TRQs) for garments, the more general case of requiring a change of tariff heading (CTH) at the 4-digit level has been burdensome for certain Sri Lankan exports. This rule has had a detrimental effect on Sri Lanka's blended tea exports where a CTH at the 4-digit level is difficult to achieve even when blended with Indian tea (Kelegama, 2001).

- Unilateral imposition of quotas

Following the surge of vanaspathi imports from Sri Lanka to India, the two countries entered into negotiations in 2003 to apply a quota on vanaspathi exports due to the disruptions caused to the Indian domestic industry. The two countries initially agreed to a quota of 250,000 metric tones per year. However, in 2006 India unilaterally reduced this quota to 100,000 metric tones. Further negotiations took place and the quote was reverted to 250,000 metric tones. Similar problems have occurred in exports such as bakery shortenings, pepper and copper. More than the disruptions to the industries as a result of such quantitative restrictions, what is of concern is the undermining of confidence in the Agreement as a whole.

Role Played by the ILFTA in Crisis Situations

As discussed before, the disaggregated trade and investment data show that the real impact of the ILFTA is far less impressive than that portrayed by the aggregate data – export growth has been concentrated in a few low value-added products and investment has not generated significant employment or technology transfer. Also, the war in Sri Lanka has seriously affected the region's two vital economic sectors – fishing and agriculture. Production of food

like rice, vegetables and fruit has also been adversely affected. After the global financial and food crises and in the context of the ongoing global economic slowdown, it becomes important to examine whether the ILFTA has played any role in attenuating the crisis and recovery effects in the adversely affected Sri Lankan economy.

The main role played by the FTA in the face of the crisis has been in providing cheap Indian imports (which are most often not produced in Sri Lanka) to Sri Lankan consumers, such as oil, vehicles, watches and pharmaceutical products, when prices of such items have been on the rise in other countries. The fact that the Indian economy has remained relatively unaffected by the economic downturn has been an additional advantage. Also, geographical proximity has enabled savings on transport related costs. However, such advantages are prevalent with or without economic crises. The ILFTA has not played any particularly significant role in mitigating the impacts of the financial and food crises, and thus it is important to look beyond the FTA in order to promote more cooperation which will enable the two countries to follow more inclusive and sustainable development policies and provide necessary safeguards against future crises.

The Comprehensive Economic Partnership Agreement: Way Forward towards Increased Integration

Given the early success of the FTA, both parties were aware of the importance and benefits of broader economic integration and thus keen on deepening and broadening the FTA, and based on the recommendations of the Joint Study Group report, it was decided to include trade in services, investment and economic cooperation, along with further liberalization of the goods sector, under the ambit of a Comprehensive Economic Partnership Agreement (CEPA). Negotiations for the CEPA began in 2005, and after three years of negotiations the CEPA framework agreement was scheduled for signature by the respective head of states of the two countries at the 15th SAARC Summit in Colombo in July 2008. However, due to the

reservations expressed by a group of local industrialists and a left-oriented political party, the CEPA was not signed during the Summit and it has remained in limbo since then.

The reservations expressed by critics of the CEPA were based on two broad concerns; the first, about the nature of CEPA itself, and the second that the drawbacks in the FTA should be dealt with first, prior to embarking on a CEPA. The first concern was largely related to the inclusion of trade in services, specifically the movement of natural persons (Mode 4) which was interpreted by the critics of CEPA as a move towards free movement of labour between the two countries. In actual fact the decision taken at CEPA negotiations was to link Mode 4 to Mode 3 until such time that Sri Lanka is ready for a de-linking them. The critics failed to take into account the fact that like the FTA, the CEPA also made room for the economic asymmetry between the two countries, and therefore accorded special and differential treatment to Sri Lanka – Sri Lanka was not expected to fully reciprocate India's commitments. Furthermore, the CEPA services agreement was based on a positive list framework, where the two countries exchange request lists for the liberalization of a specific sector and each country can choose to make an offer which is in line with their comfort levels and developmental interests. Given such flexibility, concerns about a flood of Indian labour were completely misplaced.

The second concern, that the shortcomings in the FTA should be addressed before CEPA, is counterproductive since CEPA was negotiated with the very objective of addressing the shortcomings in the FTA, such as the removal of port restrictions and ROO requirements in garments. Also, increasing exports to India requires a general change in the perceptions and preferences of Sri Lankan exporters – a process that will take time. Despite the geographic and cultural proximity between the two countries, India was not a major export market of Sri Lanka since independence, with exporters preferring developed markets in the Western world. As de Mel (2008a) points out, the restrictions on established export items mean that new export products have to be developed from scratch – economies of scale need to be

achieved, brand development must be carried out, and marketing-buyer relations must be developed. This process becomes more challenging given the large and competitive market of India. Furthermore, supply capacities in developing economies like Sri Lanka take time to develop. With the improvement of the security situation in the country, it is hoped that foreign investment in the country would gradually buildup.

With the CEPA negotiations being stopped, the only forum for addressing shortcomings of the FTA has closed. Delaying CEPA until all the issues in the FTA are addressed would delay the implementation of CEPA substantially, and would result in the hijacking of the interests of trade in services and investment, and hold up the benefits of liberalization of these sectors.

Given the fact of geographic proximity and socio-political and historical relations between the two countries, economic exchange is inevitable. Furthermore, in the context of Sri Lanka continuing to have a concentrated export basket, both in terms of destination (US and EU) and products (garments and tea), diversification becomes essential. This necessity has been highlighted in the recent global financial crisis as Sri Lanka became particularly vulnerable given the concentration of exports to the most adversely affected markets. Whilst the US and EU markets have faced a recession, emerging markets such as Indian and China have managed to sustain some degree of economic growth despite the global downturn. The Indian economy, which grew at 5.3% even in the fourth quarter of 2008, and is growing at around 7% in 2009, is likely to be among the least affected by the crisis. Had Sri Lanka maintained a more diverse export basket, the country would have been less vulnerable to external shocks.

The ILFTA has somewhat helped in shifting Sri Lanka's trade towards alternative emerging markets by encouraging exporters to move beyond their traditional buyers. This strategy will be essential in the medium to long-term given the fact that world trade can no longer rely on the unsustainable credit-based consumption booms, particularly in the US. The global

imbalances (production and savings by East Asia and the Middle East along with credit-based consumption in developed markets) that had shaped the world economy in recent years will no longer be viable, and increased domestic consumption in Asia and the Middle East will be required to re-balance the equilibrium. Given Sri Lanka's proximity and long-standing relationship with India, the country is in an ideal position to take advantage in this shift in global economic powers towards the East (de Mel 2009).

The CEPA should be seen as an attempt to manage Sri Lanka's trading relationship with India. The Agreement provides a legal framework which defines the rules and regulations under which trade occurs between the two countries. As pointed out by Samarajiva and Herath (2008), the lack of a rule-based regime to mange bilateral relations is a problem, especially for small states. While a rule-based regime that is entered into on the basis of principles of fairness by parties that are equally endowed with knowledge and power are definitely the best option, even when there is substantial asymmetry of power among the parties and the rules are not perfect, rule-based systems are superior to anarchy. Given these conditions, the continued failure to proceed with the CEPA is unfortunate and detrimental to Sri Lanka's trade policy.

While countries continue to move ahead with negotiations at various levels, the multiple and overlapping agreements of such negotiations can involve considerable transactions costs. For example, Sri Lanka has entered into bilateral and multilateral negotiations in the South Asian region such as the ILFTA, SAFTA, and APTA, each involving different rules of origins, tariff preferences, etc. In the absence of progress in regional frameworks such as SAFTA, the best option available to Sri Lanka is a bilateral framework within a rule-based disciplinary framework, because there is little forward movement in SAFTA. Also, given the fact that India is currently negotiating and implementing a number of bilateral trade agreements with much larger economies such as Japan and the EU, it would be unwise to delay or reopen the already negotiated CEPA.

Also, given the slow progress of the WTO services negotiations, Sri Lanka stands to benefit from early access to the large and growing Indian services sector by engaging in the CEPA. As incomes increase at almost double digits annually, the demand for services will continue to expand in India. Furthermore, with economic growth, wages in India have increased relative to those in Sri Lanka, and coupled with the effect of an appreciating Indian Rupee, services offered by Sri Lanka have become relatively competitive in the Indian market (de Mel 2008b). It is also possible that access to the Indian market may attract investment from third parties into Sri Lanka, looking to export services to Indians through joint ventures with Sri Lankan firms. While India's regime is at present quite liberal – it is not a guaranteed position overtime. The CEPA will provide legally binding market access to India – over and above what is available to other countries. Given Sri Lanka's limited domestic market, the required economies of scale can never be achieved without sufficient international integration. In the present climate, there is no better opportunity than the Indian market.

The experience of the current crisis has stressed the need for more inclusive and equitable trade and growth policies. The CEPA is important in this context, as increased importing of services such as health and education from India at a reasonably low cost through service sector liberalization is beneficial to the lower and middle-income Sri Lankans who face domestic supply constraints. While wealthy Sri Lankans can obtain these services from Singapore, Europe and the US, India is the only option for the poorer population. To combat the adverse impacts of escalating food prices, it is important to liberalize agricultural trade by removing import controls. The most effective trade policy response to high food prices over the long-term is greater (agricultural) trade liberalization that would allow new supplies to emerge, particularly in developing countries. Increased access to new technology and investment is also important in modernizing and improving productivity in the agricultural sector. By providing deeper integration of the two economies, the CEPA will facilitate more

investment and technology flows from India to Sri Lanka, thereby providing scope for development of the agricultural sector in responding to the food crisis.

Concluding Remarks

The key opportunity for Sri Lanka is to tap into the large and dynamic Indian market, by moving beyond the ILFTA towards broader economic integration. The CEPA, implemented with proper regulatory mechanisms in order to accommodate the disparity between the countries, provides an opportunity for Sri Lanka to integrate more closely with the Indian economy and accrue some of the benefits that would undoubtedly be enjoyed by India. Today, as an economic crisis grips Sri Lanka's traditional export markets and a food price crisis engulfs the global economy, Sri Lanka should view India as an opportunity and not a threat, and strive towards more meaningful cooperation in facilitating inclusive and equitable development policies.

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