

Assessment of the Performance of the Indo-Sri Lanka Free Trade Agreement (ISFTA)

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The conclusion of the Framework Agreement of the ISFTA in December 1988 at the highest political level and subsequent implementation in March 2000 marked an important milestone in India – Sri Lanka relations and in trade relations, in particular, as it concretized bilateral relations and paved the way for closer economic integration. The bilateral FTA imparted much needed impetus to Sri Lanka in her endeavours to enhance market access for her products in the Indian market.

Consequent to the delayed implementation of the ISFTA in March 2000, divergent views have been expressed on whether the Agreement has produced the expected results.

Macro position of bilateral trade between Sri Lanka & India

As observed from the **Table 2** while, imports from India grew from Rs. 53.7 bn. in 2001 to Rs. 79.8 bn., in 2002 by 48.6%, **imports/export ratio** improved from 8.6:1 to 4.9:1 and **import coverage ratio** which acts as the barometer to measure the extent to which export proceedings can cover the disbursement on imports, improved from 11.6% in 2001 to 20.23% in 2002. During the year 2002, value of exports from Sri Lanka recorded a 158% growth on year-on-year basis.

India which stood as the 22nd buyer of Sri Lanka in 1990 accounting for only 1.1% of the value of Sri Lanka's total exports, emerged as the 5th largest buyer accounting for 3.6% of the value of total exports (Rs. 448,353 Mn.). The portion

of Sri Lanka's exports absorbed by India (Rs. 16,153 Mn.) is equivalent to 9.6% of value of Sri Lanka's exports to the USA (Rs. 168,596 Mn.), our main export market during the same period.

Performance of preferential exports under the FTA

Value of preferential exports (Rs. 10,930 Mn.) is equivalent to 68% of Sri Lanka's total exports to India amounting to Rs. 16,153 Mn. in 2002 as against 23% in the previous year. It is a clear indication that the rate at which tariff concessions are being utilized by the exporters in Sri Lanka is on the increase.

According to **Table 2**, value of exports in terms of US \$ under the FTA from Sri Lanka to India has risen to US \$ 114.3 Mn. in 2002 from US \$ 15.9 Mn. in 2001, registering an impressive growth rate of 620% as against 54% in 2001 on year – on – year – basis (In the absence of uniformity of the periods under review, monthly averages were used in analyzing the growth dynamics of Sri Lanka's exports to India).

In order to have a realistic assessment of the growth dynamics of preferential exports under the FTA, micro analysis should be performed on the composition of preferential exports in an objective manner. In the light of the detailed statistics of preferential exports at **Annex 1**, it has been observed that the growth momentum of preferential exports has been propelled by copper related products namely, copper ingots, wire bars, billets and copper wire which have collectively accounted for 63% of the value of total preferential exports in

2002 (Rs. 10,930 Mn. or Us \$ 114.3 Mn.) as against 10% in the year 2001.

Performance of preferential exports under the FTA excluding copper related products

In the light of the **Table 4**, it has been observed that total preferential exports minus copper related products hereinafter referred to as "**other products**", have recorded a remarkable growth rate of 192% in the year 2002 when compared with the growth rate of 43% in 2001 in terms of US \$.

Waste paper, which appeared as the largest item of exports under the FTA in 2000, accounting for 43% of the total export earnings remained as the major item among non-copper exports, accounting for only 5% of value of exports in the year 2002. It is noteworthy that value of exports of Dual Inline Memory Modules (DIMMs), a part for computers, has increased from Rs. 5.4 Mn. in 2001 to Rs. 483.7 Mn. in 2002 posing an exponential growth rate of 8300%. DIMMs entered the Indian market subsequent to the implementation of the FTA. Furniture, next item featuring prominently among top ten of non-copper exports, registered a remarkable upswing in its export earnings from Rs. 46 Mn. in 2001 to Rs. 144 Mn. in 2002 projecting a continuous growth trend even despite discriminatory sales tax imposed in Tamil Nadu state to which bulk of exports of furniture was destined. Similarly, pneumatic tyres with a value addition of more than 50% and with a contribution of 1.3% to the total preferential export earnings in 2002 appeared among top ten non-copper exports to India under the FTA.

Basic customs duty reduction commitment as per the FTA

Table 1

No. of Tariff Lines in (in 6 - digit H.S. 1996 Code)

	Sri Lanka's Commitment	India's Commitment
Null Negative List (Virtual)	1,180	196
50% (fixed) – Garment Quota	—	233
100% (Zero duty)	319	1,351
50% (Phased out to 100% in 3-years)	889	2,799
50% (fixed) – Tea Quota	-	5
25% (fixed) – Textile items	-	528
Up to 100% in 8 – years	2,724	-
Total No. of Tradable items	5,112	5,112

Macro position of bilateral trade between Sri Lanka & India

Table 2 Sri Lanka – India Trade

Year	Imports Rs. Mn.	Exports Rs. Mn.	Trade Balance	Import/Export Ratio	Import Coverage
1996	31,055.6	2,256.1	(28,799.9)	14 : 1	7.26%
1997	33,023.5	2,524.3	(30,499.2)	13 : 1	7.64%
1998	35,837.7	2,279.4	(33,558.3)	15.7 : 1	6.36%
1999	36,012.9	3,320.3	(32,692.6)	11 : 1	9.22%
2000	45,477.1	4,217.3	(41,259.8)	11 : 1	9.27%
2001	53,750.0	6,265.7	(47,484.3)	8.6 : 1	11.60%
2002	79,847.1	16,152.9	(63,694.2)	4.9 : 1	20.23%

Source: Sri Lanka Customs

The following items of exports featured prominently among first 20 products of exports under the FTA to India:

Copper products (63%), waste paper (5.3%), Dual inline memory modules (4%), black pepper (3.4%), pine resin (2.5%), lead ingots (2.2%), naphthalene (2.5%), iron scrap (1.7%), copper scrap (1.6%), furniture (1.3%), tyres (1.3%), aluminum scrap (0.9%), high density fibre board (0.9%), energy saving bulbs (0.9%), marble slabs (0.7%), mace (0.6%), tin ingots (0.6%), multi wall paper sacks (0.4%), copper dross (0.44%), palm oil (0.3%) and Samahan (0.3%).

In the light of the Table 5 it has been observed that the first ten products have accounted for 85% and the first 20 products have accounted for 94% of the total value of preferential exports, depicting a high degree of concentration on a few products.

Utilization of quota for readymade garments and tea

As in the previous years, utilization of quota for tea (15 Mn. Kgs.) and readymade garments (8 Mn. pieces in 2002) remained at a dismal level of below 1% of quotas available. Lack of marketing efforts, pre-occupation with traditional markets, absence of brand names etc. remained as main reasons for under utilization of quota on ready-made garments, whereas inadequate marketing efforts, uncompetitive prices etc. were considered as main reasons for poor performance in the utilization of tea quota.

New products exported to India subsequent to the implementation of the FTA

It is encouraging to note that a number of new products have entered the Indian market consequent to the implementation of FTA.

Table 4

	2000 (March - Dec.)	2001	2002
Exports under FTA	634	1,423	10,930
Less			
Copper products	-	146	6885
Other Exports	634	1277	4085
Exchange rate	75.78	89.36	95.66
Other exports US \$ Mn.	8.4	14.3	42.7
Monthly average US \$ Mn.	0.84	1.2	3.5
Growth in monthly averages of other exports	-	43%	192%

Other exports = Total exports - Copper related products

Source: Certificates of Origin issued by Department of Commerce

Table 3

Year	Rs. Mn.	US\$ Mn.	Monthly average US \$ Mn.	Growth in monthly average % US\$
2000 (March-Dec.)	655.11	8.60	0.86 (8.6/10)	-
2001	1,422.5	155	1.32 (15.9/12)	53.5
2002	10,929.9	114.3	9.5 (114.9/12)	620.0

Source: Certificates of Origin issued by Department of Commerce

The aggregate value of exports of new products under the FTA has dramatically increased from US \$ 6.5 Mn. in 2001 to US \$ 43.4 Mn. in 2002 recording an exponential growth rate of more than 500% on - year - on - year basis. The products which contributed to such a growth include copper ingots, wire-bars and billets (Sr. No. 41) tyres (Sr. No. 21), H.D. fibre board (Sr. No. 23), furniture (Sr. No. 57) of Annex III, a list of new products. It can be seen that new products such as multiwall paper sacks, marble slabs, ceramicware, jewellery, ice cream machine, furniture etc. have shown a sustainable export capability during the period under review whereas export items such as soft drinks, polyester spun yarn, gloves, saneeppa slippers, sandals, fibre products, measuring devices, safes, lighting fixtures, prefabricated buildings (roof), etc. which entered into the Indian market in 2000 and 2001 consequent to the implementation of FTA could not be sustained in the year 2002.

FDI and Employment

As a result of the FTA with India, according to the estimates of the Board of Investment of Sri Lanka, about 40 investors (majority of them Indian nationals) have invested in Sri Lanka to the tune of US\$ 30 million creating about 1200 employment opportunities, mainly in rural areas.

Composition of preferential exports

It has been observed that the Indo - Sri Lanka Free Trade Agreement has played a key role in enhancing appreciably the quantum of exports, both in terms of volume and value from Sri Lanka

to India. However, it has also been observed that the bulk of preferential exports under the FTA is not for direct final consumption and can be considered as intermediate products which are required by the Indian industries. It has also been observed that the domestic value addition of as much as 80% of the preferential

export ranges between 35% - 40% of the FOB value. Companies owned by Indian nationals are accountable for about 80% of the preferential exports.

Tariff reduction commitment in post March 2003 period

In the light of the Table 7, import duties applicable on 4,150 tariff lines are duty free now, under the FTA.

Import from Sri Lanka

India has emerged as one of Sri Lanka's main suppliers in the recent past, even prior to the implementation of the FTA and particularly during the last decade. India gradually emerged more as a supplier to Sri Lanka than a market for Sri Lanka's export products. The emergence of India culminated in the last few years by becoming the main supplier to Sri Lanka accounting for about 13% of the value of the Sri Lanka's total imports. The import pattern of Sri Lanka in the recent years, suggests that Indian imports will continue to increase substantially in the years to come since India is in a position to replace other suppliers to Sri Lanka with the advantage of concessions under the FTA. However, these imports are coming on the basis of "need to source from outside" and India fitting into the need. It is inevitable that due to the FTA, some of the products of Indian origin which would have been non-competitive otherwise, may enter the Sri Lanka market.

Direction of Sri Lanka's trade has distinct characteristic features. Her main suppliers such as India, Japan, Hong Kong, Taiwan, Singapore, etc. are in the East whereas her major buyers or markets such as USA, EU etc. are in the West. Sri Lanka's major suppliers are not necessarily Sri Lanka's major buyers, except

Table 5

Degree of concentration of exports in terms of value	
	% to total preferential exports
(1) First Product (copper products)	63
(2) First ten products	85
(3) First twenty products	94
(4) All (94) products	100

Table 6

Year	Rs.Mn.	U.S. \$. Mn.
2000 (March - Dec.)	99.2	1.3
2001	583.7	6.5
2002	4167.9*	43.4

Source: Certificates of Origin issued by Department of Commerce

* Excluding copper wire (H.S. 7408.11/19) which was exported only in the year 2002, during the period under review.

Japan, resulting in favourable balances with the countries in the West and unfavourable balances with the countries in East. As mentioned earlier in this report, India emerged more as a supplier to Sri Lanka in terms of consumer, intermediate and capital goods and therefore, an unfavourable trade balance with India is inevitable in the macro context.

The other factor which causes a trade balance heavily in favour of India is the **asymmetries of economies** in terms of export base, excess capacity, raw material supply base, degree of industrialization, lower freight charges, availability of skilled manpower etc.

Today in the global context, bilateral trade balances is a crude indicator in measuring strengths and weaknesses of an economy. As long as overall trade balance is at a satisfactory level, a heavily unfavourable bilateral trade balance with a single country may not be a matter of grave concern.

Issues arising in the implementation of FTA

There is a perception among certain quarters that there are many problems in implementing the FTA. The Department of Commerce being the focal point in Sri Lanka for the ISLFTA, which is the issuing authority for certificates of origin, is the first authority to know if Sri Lankan exporters face any problems on the FTA. The Department of Commerce gets to know the issue even before the Indian Government is aware of it. Certain problems which arose during the first year of implementation were teething problems and would arise in implementation of similar agreements with any country. A recent study concluded by the UNCTAD noted that "perception bias" is one of the main reasons for lower South - South Trade. This applies to Indo - Lanka FTA too where initial implementation issues were blown out of proportion creating

an impression that such problems have negated the benefits of the FTA. It has been observed that even in the developed countries, particularly in the post Uruguay Round era there was a tendency to erect non-tariff barriers when import duties (tariff barriers) were reduced or eliminated. Viewed in this context, India cannot be an exception to the general trend.

During the period March 2000 to end 2002, Sri Lanka has effected 4600 shipments to India under the FTA, of which less than 50 consignments were subject to un-anticipated delays at the point of clearance due to reasons such as customs valuation, application of TBT (Technical Barriers to Trade) and SPS (Sanitary and phyto-sanitary standards), non availability of specimen signatures of authorized officers of Sri Lanka at certain customs entry points in India etc. Violation of the principle of National Treatment (discriminatory sales tax in Tamil Nadu) was also observed. Most of the delays in clearance of export shipments were of non repetitive nature due to the effective intervention of the Trade Officers stationed in Mumbai and Chennai.

Majority of such delays can not be construed and interpreted as major obstacles in implementing the present FTA. Such delays mainly occur during the first years of operation due to lack of awareness and experience in implementing a FTA. The recurrence of such issues has already reduced to a larger extent with the passage of time.

It must also be kept in mind that Sri Lanka's overall export base was mostly geared to cater to developed country markets and most, if not all exporters were pre-occupied with the vagaries of such markets and scant attention had been paid to market access opportunities created in the Indian market through the FTA. Although India is our closest neighbour, the Indian market for a large number of our exporters is a relatively new and untapped market and knowledge of how to do business with India appears to be lacking among our private sector.

Under such considerations, the mere existence of tariff concessions by itself does not beget enhanced volumes of export. Further, exaggeration of the implementation problems our exporters faced dur-

ing the first year of implementation may have also created a 'dampening' effect on prospective exporters to India.

It must also be noted that political economy dimensions of India's foreign trade policy management can not simply be overlooked in any analysis or research on the ISFTA.

Proposals to enhance bilateral preferential exports under the FTA

(a) Recognition by India of the conformity assessment procedures of the Sri Lanka Standards Institution (SLSI)

In line with the item No. 13 of the minutes of the meeting at Commerce / Finance Secretaries' level held in New Delhi in February 2000, a MOU has already been signed between SLSI and Export Inspection Council (EIC) of India recognizing conformity assessment procedures of EIC in respect of products which are subject to the Compulsory Import Inspection Scheme in Sri Lanka being implemented by SLSI. Sri Lanka's proposal for a similar MOU between SLSI and the Bureau of Indian Standards (BIS) has not yet been agreed to by the Indian side.

(b) Rules of Origin (ROO)

According to the Rules of Origin Criteria of the ISFTA, "originating status" is conferred on a product provided; it complies with the following criteria. Only originating products are eligible for tariff concessions under the FTA:

- (a) If a product is wholly produced or obtained in the territory of Sri Lanka.
- (b) Where product is not wholly produced or obtained in the territory of Sri Lanka, the said product should comply with requirements governing substantial transformation or sufficient working or process which are detailed as follows:
 - (i) Value of the imported input should not exceed 65% of the FOB value of the finished product, and
 - (ii) Conversion of HS Nos. between non originating input and the finished product should take place at 4 digits H.S. Code level,
 - (iii) The processes involved in transformation should not be one of processes which are considered as insufficient working or processing even though H.S. Transformation takes place as indicated (ii) above, in addition, the final process of manufacture should be performed in the territory of Sri Lanka and the consignment should be directly shifted to India,

Tariff reduction commitment in post March 2003 period

Table 7

	Sri Lanka's Commitment	India's Commitment
Nil (Negative List)	1180	196
50% fixed - Garment	-	233
Zero duty	1208	4150
50% - fixed - Tea Quota	-	05
25% - fixed - Textile items	-	528
35% - increased to 100% in 8 years	2724	-
	5112	5112

(iv) In the case of Cumulative Rules of Origin where inputs are sourced from India, the domestic value addition in Sri Lanka should be at least 25% of the FOB value of the finished product where as the aggregate value addition should not be less than 35% of the FOB price.

If a product being manufactured utilizing imported inputs should satisfy the above Rules of Origin Criteria in order for such product to obtain the originating status.

In the course of implementation of the FTA certain industrialists were of the view that the Rules of Origin Criteria are too rigid to be complied with considering the narrow raw material base and the degree of industrialization in Sri Lanka.

Therefore, the following is proposed to inject a degree of flexibility to the ROO:

- Doing away with the requirement of conversion of HS Nos. at 4 digit level where the Domestic Value Addition (DVA) exceeds 40% of the FOB of the finished product.

A similar approach has been adopted by the MERCUSOR countries. It has been observed that no FTA or RTAA other than the Indo - Sri Lanka Free Trade Agreement and Indo - Nepal Free Trade Agreement apply **across - the-board**, conversion of HS requirement between non-originating inputs and the finished product at 4-digit level.

In granting originating status for a product, the percentage value addition requirement should take precedence over the requirement of HS conversion. e.g. Where DVA is 50% of the FOB value, it is meaningless to check whether the conversion of HS Nos. between non-originating inputs and the finished product has taken place.

Even in the case of NAFTA Rules of Origin, requirements for conversion of HS code have been designed, more or less, for each and every tariff line or a group of tariff lines. In some cases, conversion of HS Nos. should take place at 6-digit level. As mentioned earlier, MERCUSOR has adopted a higher percentage DVA where conversion of HS Nos. at 4-digit level does not take place between non-originating inputs and the finished product. Most importantly, due to the

application of General Rule 2 (a) of the Harmonized System in certain instances, H.S. Conversion does not take place between non-originating parts and the finished product.

Secondly, it is also suggested to apply de-minimums where CIF value of a non-originating input is less than 7% of the FOB value of the finished product, the requirement of conversion of HS Nos. between such non-originating inputs and the finished product should be dispensed with.

Thirdly, in order to encourage exporters to source inputs from each other wherever possible, when a contracting party has imported inputs from the other contracting party such inputs should be considered as originating inputs in the exporting contracting party and hence the requirement of conversion of HS Nos. should be dispensed with.

At present even if the imported content of a product of Sri Lankan origin is minimal i.e. 5% - 7% of FOB, the product is not eligible for tariff concessions in India though the Domestic Value Addition is 35% or higher of the FOB if the conversion of HS Nos. at 4 digit level does not take place between imported input and finished product.

Fourthly, where input originating in the importing country is incorporated in a product originating in the exporting country, suggest that the importing country should levy import duty only on the value added component.

Issues at Policy Level remaining to be resolved

A sales tax of 11.5% is levied on locally manufactured items whereas like products of foreign origin including that of Sri Lanka are subject to 21%. This discriminatory sales tax is a violation of Article V (National Treatment) of the FTA and has led to an impairment of negotiated concessions on the basic customs duties.

Measures proposed to further maximize benefits under the ISFTA

The main thrust of reaping maximum benefits out of market access opportunities created by ISFTA hinges upon the degree of enthusiasm and involvement of the private sector, since the flow of actual exports is really driven by them. Therefore, any proposed measures should be private sector - centered with effective and sufficient support of the government machinery at appropriate stages.

1. It is suggested that a study be undertaken to identify whether major exporting firms of Sri Lanka are in fact exploiting market access opportunities created by the ISFTA.

- If not, reasons for lack of enthusiasm should be identified and however, they should be effectively encouraged to exploit opportunities.

As noted earlier, if existing Sri Lankan exporters remain unenthusiastic about the ISFTA, a fundamental question arises as to how Sri Lanka's objectives in terms of export earnings, employment creation etc. can be achieved.

- If yes, the existing exporter should be strongly encouraged to achieve at least 30% growth in terms of export earnings in US \$ on year-on-year basis over a period of next 5 years. I reiterate that, the private sector as "the engine of growth" should necessarily have to take initiatives and play the major role with public sector facilitation in the export promotion drive.

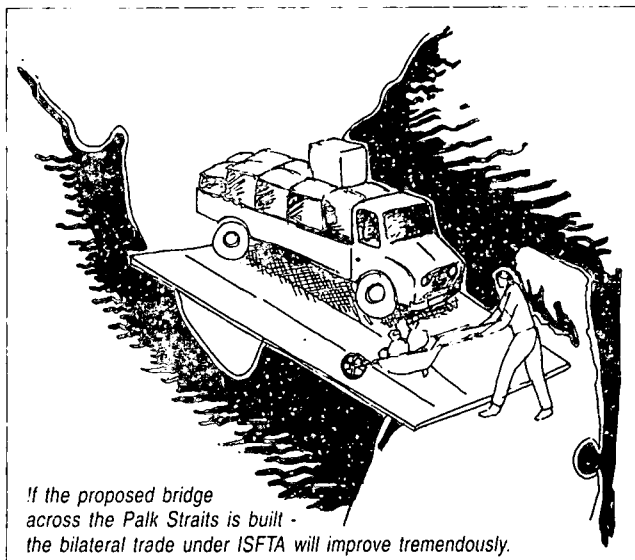
2. Attracting foreign investors to Sri Lanka for export oriented ventures with an emphasis on Indian market.

It is suggested that a study be undertaken by the BCI with the objective of identifying exactly what new products can be manufactured in Sri Lanka based on **comparative advantages**, aiming at foreign markets with an emphasis on the Indian market, and accordingly, an aggressive investment promotion campaign should be undertaken to attract both foreign and local investors for export oriented business undertakings, manufacturing such products.

3. A study should be undertaken to identify Indian investors with buy back arrangements.

4. A study should be undertaken to identify products which can be jointly manufactured in India and Sri Lanka and marketing them in third countries' markets.

Contd. on Page 33



If the proposed bridge across the Palk Straits is built - the bilateral trade under ISFTA will improve tremendously.

5. Organizing selling missions to India to promote identified products. Companies like Colombo Dockyard which manufactures high value item such as boats which are eligible for zero duty should undertake such visits.
6. At the First Joint Ministerial Committee Meeting held in July 2002, Sri Lanka gained additional concessions on 51 items of readymade garments. FTZMA garment exporters need to undertake an aggressive marketing campaign in India with the firm resolve of securing more benefits, outweighing the cost of offer. India has given effect to such additional concessions with effect from 12th November 2002.
7. A separate export promotion budget under the FTA should be set up, with a view to defraying certain specific promotion related expenses to be incurred by Small and Medium scale Exporters (SME) to India.
8. Appointment of an Indian consulting group to undertake promotion of Sri Lankan exports and investments arising from the benefits of FTA are of priority. The Indian Line of Credit could be utilized for this. A case in point where an Indian company has been able to sell Sri Lanka among the Indians is the appointment of an Indian company to sell Sri Lanka to the Indian tourists. This has been an importers.
9. There is also a need to create a lobby for Sri Lanka among the industry groups which feel threatened by the competitiveness of Sri Lanka products. Tea, meat products, furniture, biscuits and confectionery are some of such sectors which feel

threatened. Indian industrialists who form a powerful sector have access to the political leaders as well as the media may have been responsible for the imposition of sales taxes, implementation of stringent standard requirements etc. The Sri Lankan diplomats based in India should also cultivate the various industry lobbies so that they do not take on Sri Lanka as a competitor. Successful example of such lobbying was apparent with the Clothing and Manufactures Association in Mumbai where the Mumbai garment exporters Association agreed to support the import of garments from Sri Lanka.

The Sri Lankan Government leaders could also use their friendship with state leaders to persuade them to remove remaining obstacles to the growth of imports from Sri Lanka.

The Ceylon Chamber of Commerce which is the nodal chamber for the FTA should use its influence with the Indian chambers to soften these lobby groups through their counterparts. Exchange of delegations is one such measure while tying up with them as joint venture partners is another such measures. The Ceylon Chambers must use their links with the Indian Chambers to promote the FTA. Informative articles with the support of the CII all in the media and business journals exchange of business delegations, visits to Sri Lanka by top Indian businessmen (Tata, Birla, and Reliance Groups) would also be useful.

Built in limitations against creating import surges in the Indian market

In terms of Article VIII (Safeguard Measures) of the ISFTA, if any product, which is the subject of preferential treatment under this Agreement, is imported into the territory of a Contracting Party in such a manner or in such quantities as to cause or threaten to cause, serious injury to the importing

Contracting Party, the importing Contracting Party may, with prior consultations except in critical circumstances, suspend provisionally without discrimination, the preferential treatment accorded under the Agreement.

In view of the safeguard clause and political economy dimensions of India's trade policy management as mentioned earlier in this paper Sri Lanka's export growth pattern under the ISFTA to India should be a gradual and meticulously monitored one.

Conclusion

Possibilities for further maximization of benefits for Sri Lanka, utilizing hitherto untapped market opportunities available under the FTA are immense. The proposed land bridge as well as the ferry service further enhance the potential for trade to develop.

Most importantly, the degree of attractiveness of concessions of FTA with India to promote Sri Lanka as "gateway" to the huge Indian market both for export and investment will not last forever. With the passage of time when India reduces her MFN import duty rates either through future rounds of trade negotiations at multilateral level or through voluntary liberalization, the strategic position of Sri Lanka stands to erode gradually, since the strengths of tariff concessions to drive exports from Sri Lanka and attract investment into Sri Lanka will diminish. Similarly, once India concludes a FTA with ASEAN countries probably by 2010, the strategic position of Sri Lanka will drastically get eroded. Hence, it is of utmost urgency for Sri Lanka to exploit the tariff concessions which are very attractive at present, to establish concrete relations with Indian importers and investors as fast as possible, as this "window of opportunity will not be open forever.