

NORTH AMERICAN FREE TRADE ASSOCIATION AND ITS IMPLICATIONS ON SRI LANKA'S RUBBER EXPORTS

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The dependence of all countries in today's world, on the international community for their economic growth and survival has increased to unprecedented levels. This requires heavy adjustment on the part of each country, even to maintain their present relative position in the world economy, into the future.

Many threats are in the air. An effective strategy, to be implemented in order to convert these threats into opportunities, is to adjust fast to these environmental changes causing threats, fully utilizing the strengths of individual countries. This strategy is equally applicable for non-member countries of NAFTA to face the challenges and to convert threats that come in the form of NAFTA rules, into opportunities.

1. The Changing World Trade Scenario

According to the basic principle of "comparative advantage", countries benefit from concentrating on areas of trade where they have relatively better scarce resource capabilities and by leaving alone those activities where they have relatively lesser capabilities in. Translation of this simple concept into realities is not quite as simple. Countries and people may not necessarily specialize in what they can do best; nor are the rewards for doing so always comparable.

Moreover, completely free trade has seldom prevailed in the world. Restrictions on international trade are imposed by governments for various strategic reasons. They may be on the avowed pleas of protecting local industries and employment, or perhaps to preserve some form of short-run balance in the country's foreign payments capabilities. Some developing countries may also be faced with the problem of having a limited number of products for export.

A recent study of a group of 86 developing countries by the UNCTAD Secretariat revealed that only one-third of these countries have been able to achieve a significant reduction in their traditional dependence on earnings from commodity exports: Two-thirds still remain heavily commodity exports dependent. Half of them

even experience an increased reliance on one, or two, major export commodities. These data should be a matter of concern to the world community at large.

Let us have a look at World market conditions which are changing at a substantial rate. During the last decade, the United States – still the most significant economic market in the world – still the most significant economic market in the world – lost some of its economic power. Japan is developing at a rapid rate; so rapid that it is historically unique. Newly industrialized countries in the Far East are emerging. The effects of the Eastern European liberalization movement have opened up the entire set of centrally planned economic systems which existed since early part of this century. They are becoming more market oriented systems are beginning to face up to all the difficulties of this evolving process.

Political changes in Eastern Europe and the unification of the European community are inseparably linked with the turbulent developments in Europe. The formation of five trade clusters, namely, (a) USA and Latin America, (b) the European Economic Space, (c) Japan and the Pacific rim counties, (d) Russia and CIS, (e) China and the Tigers with an internal focus, has taken place. These clusters will be the primary stimulants for global competitiveness and growth for the border zones? Trends towards world trade, or trends in protectionism?

The object of this paper is to identify the likely threats resulting from the implementation of the NAFTA agreement and to propose some strategies that can be adopted by the Sri Lankan exporters.

2. Importance of the North American Continent as an Export Market

North America comprises three large countries: viz USA, Canada and Mexico. These three countries together had a total population of 366.8 million in 1992. Sri Lanka has been trading with this region during the past few decades. In 1992 this region accounted for about 30 percent of the value of total exports of Sri Lanka; it yields a gross export trading income greater than from any other trading bloc in the world. Table I indicates the relative position of each trading bloc. It is evident that from 1986 to 1991, Sri Lanka's trade with the North American Region had accounted for about 27 percent of the value of the total annual exports.

The data show the importance of the North American region to Sri Lanka relative to the other regions referred to. USA, the biggest trading area in the region, has been ranked to be the country bringing in the largest annual export earnings for Sri Lanka.

The balance of import/export trade with this region has been in Sri Lanka's favour. During 1992 total imports from this region constituted only 5.6 percent of total Sri Lankan imports. The overall trade surplus in 1992 was Rs.30 699 million, a 27.8 percent share of the value of Sri Lanka's total exports during 1992. The striking feature

Table 1. *Percent share of the value of exports from Sri Lanka to various trade blocs (regions) of the world (1986-1992)*

Region	Percentage of the total annual exports						
	1986	1987	1988	1989	1990	1991	1992
1. North America	27	28	27	28	27	30	36
2. EC	28	27	27	30	30	30	31
3. Middle East	18	19	18	16	17	13	10
4. Far East	8	8	9	8	7	7	2
5. Asean	3	6	5	7	4	5	2
6. Other	14	12	14	11	15	15	19

Source: Central Bank of Sri Lanka 1992

with respect to Sri Lanka's exports to this region is this trade surplus. This surplus alone is greater than the value of total exports to all the other regions of the world (excluding exports to the EC).

The importance of the annual value of exports to this North American region may be highlighted by comparing this share of the value of exports in the total GDP to the value of exports of Sri Lanka to other regional blocs. In 1992, the share of export value to this region as a percent of total GDP of Sri Lanka was 27.8. Such comparisons indicate the importance of trade with this region to the total economy of Sri Lanka. It is possible to analyse trade between Sri Lanka and the North American region in numerous ways so as to arrive at some final conclusion about the importance of this region for Sri Lanka.

Table 2: *Value of Sri Lanka Export to USA, Canada and Mexico (Rs.Mn.)*

	1988	1989	1990	1991	1992	1993
USA	11 683	14 419	19 731	23 079	36 707	48 649
Canada	718	922	1 163	1 323	1 670	1 751
Mexico	392	621	734	828	869	884

3. Formation of the NAFTA and its effect on Sri Lankan Exports

The basic advantage of forming economic blocs is the provision of duty free access or a considerable reduction of tariff for products as benefits to the contracting parties to the trade agreement. This will create an undue price advantage for member countries over the products entering from countries outside the agreement.

However, tariff alone does not decide the demand factor because it may depend on other variables such as labour cost, turnover taxes and freight *etc.* If one element of this structure is going to be costly, the demand will be absorbed by the countries where comparative advantage is high.

The formation of NAFTA basically allows tax free entry of most items into the markets of member countries. Mexico one of the signatories to NAFTA is a developing nation having some export products similar to Sri Lanka, basically labour intensive. It would be reasonable to infer that, NAFTA will create undue price advantages for Mexico over other suppliers including Sri Lanka when the following elements are considered.

1. Tariff free entry
2. Less freight cost due to close proximity to us
3. Cheap labour comparative to US conditions.

However, one cannot come to a firm conclusion in this regard directly, as the size of the US market will also play a leading role in this context.

The threats for Sri Lankan exports can mainly arise as a result of competitive advantages Mexico will have over such exports with the implementation of the NAFTA agreement. In other words the demand for Sri Lankan products in US and Canadian markets will depend on how competitive Sri Lankan products would be in these markets against Mexican suppliers and other world suppliers. The effect from other world suppliers can be eliminated from the discussion as they will not receive any benefits from NAFTA agreement compared to Sri Lanka. What we have to evaluate is how competitive Sri Lankan products would be as against Mexican products mainly in relation to price, quality and regular supplies once NAFTA is implemented.

4. Importance of North American region as an export market for Sri Lankan rubber

Rubber constitutes a major share of total export earnings of Sri Lanka. This share was approximately 13.5% in 1992 securing the 4th place as an export earner for Sri Lanka. Further, rubber has maintained its position as a major export earner for a

long period of time. Therefore, the importance of rubber exports (rubber in raw and manufactured forms) as a single sector plays a dominant role in respect of our exports. Rubber is naturally grown in Sri Lanka and the exports of rubber either in natural or manufactured forms will bring almost 100% net foreign exchange earnings into the country. Therefore any reduction in volume of exports of rubber could reflect adversely on the country's balance of payments.

Rubber manufactures include items such as tyres and tubes, all forms of automobile components, solid tyres, rubberized coir, rubber mats and flooring, rubber shoes, surgical and non-surgical gloves V-belts, air bags, etc. Sri Lanka earns a higher volume of foreign exchange as a result of exporting manufactured rubber than through exports of rubber in natural form. In 1993 alone exports of manufacture rubber amounted to Rs.4 277.3 Mn. whilst earnings of rubber in natural form earned only Rs.3 086.3 Mn. to all countries. For the NAFTA countries (USA, Canada and Mexico) the total manufactured rubber exports were in the region of Rs.1 658.5 Mn. whilst the comparative figure for rubber in natural form amounted only to Rs.374.5 Mn. These exports of manufactured rubber to NAFTA accounts for 38.7% share of our total manufactured rubber exports by value to the world. These data show the significance of Sri Lankan rubber exports to the NAFTA countries and more particularly the importance of export of manufactured rubber.

5. Impact of NAFTA on Sri Lankan rubber Exports

Under the NAFTA agreement one of the key provisions is the "Rules of Origin"² which restricts import of products of non NAFTA content into the region to a great extent. Rules of Origin waive tariffs only on goods produced in the North American Region. The products wholly manufactured in USA, Canada or Mexico and made of using North American components will qualify for duty free concession. There are two types of "rules of origin". One rule specifies that the products produced in the region using raw materials and inputs which cannot be produced or available in NAFTA countries could qualify for tariff concessions. This is called "tariff shifting rule". The non NAFTA inputs should be in a different HS chapter.

Second type is the "value content rule". In respect of each product there should be a certain set percentage (50% - 60%) of North American content. (Either in labour/raw material or processing). The import items will be subject to value content rule only when they fail to qualify under tariff shifting rule. It is clear that

² Business America - October 18, 1993
U.S. Department of Commerce

both rules gear to impose a certain percentage of NAFTA inputs in the case of all finished products and substantial level of processing done in the North American Region. Under the NAFTA, "rule of origin" we assume that natural rubber exports into this region will not be affected since rubber is a tropical product and cannot be grown in temperate climates of the North American Region. However, since the rule of origin requires a substantial amount of North American processing, the manufactures rubber products would be affected. Therefore, it is pertinent to consider the volume/value of exports of Sri Lankan rubber to NAFTA countries in the forms of natural and manufactured to assess the effect of NAFTA rules of origin effect.

Presently the imports of natural and manufactured rubber from Sri Lanka by NAFTA countries are as follows:

Table 3. Imports of natural/manufactured rubber by NAFTA countries from Sri Lanka in 1993

	USA	Canada	Mexico
	Rs. Mn.	Rs. Mn.	Rs. Mn.
Natural rubber	304.8	31.3	38.4
Manufactured rubber	1186.6	97.4	-
Total	1491.4	128.7	38.4

Source: Sri Lanka Customs

The above figures show that Sri Lanka is exporting a large volume of manufactured rubber to USA and Canada which constitute 77.4% share of the total rubber exports into the NAFTA countries. Presently, Sri Lanka also receives GSP treatment for the products exported to USA, hence Sri Lanka receives preferential treatment for our rubber products. If NAFTA provisions are implemented, manufactured rubber products will be subject to a tariff as a result of these products not having any form of North American content. Presently we export a large volume of Inner Tubes (Rs.324.6 Mn. - '93), Retreaded Tyres (Rs.10.4 Mn. - '93), Medical Gloves (Rs.530.5 Mn. - '93), Non Medical Gloves (Rs.60.9 Mn. - '93), Floor Coverings (Rs.65.3 Mn. - '93) to the US market.

In the case of the Canadian market too the major items are Inner Tubes (Rs.16.2 Mn. - '93), Medical and Non Medical Gloves (Rs.29.2 Mn. - '93). These figures show the importance of manufactured rubber items in these two major markets. If a tariff is imposed under the NAFTA rule of origin, there will be a price increase

for the NAFTA consumers which will in turn reduce the share of our exports. The effect of this will be felt by the manufacturing firms.

There will be a number of repercussions if NAFTA provisions are implemented, because NAFTA Rules of origin specifically impose barriers on the import of products without a North American content either by way of raw material, labour or processing. Although we are unable to assess the actual impact of these rules in exact terms on our rubber products, we can reasonably assume that the NAFTA rules will pose a threat on imports of manufactured items into the NAFTA region.

Conversely the rules of Origin will affect the demand and price factor for rubber products from Sri Lanka. Presently all manufactured rubber products into USA from Sri Lanka have duty free access under GSP. If NAFTA rules of origin apply, there will be a duty on rubber products since they are not having North American content or processing. In such a case, our products will become uncompetitive against similar products made in NAFTA region since those items will receive exclusive duty free treatments under NAFTA provisions. In such a situation the overall demand for our products will tend to decline. On the other hand this encourages rubber growing countries to export rubber in raw form rather than in final product form, which is beneficial for NAFTA region since they can develop their industries and increase employment opportunities etc especially in view of the availability of labour at comparatively low costs.

In analyzing the statistics, we observe that a large volume of trade in rubber manufactures is contained among NAFTA nations themselves. In 1991 USA imported following amounts of rubber products from Mexico and Canada and from other nations.

Table. 4 *Value of imports of rubber products by USA in 1991*

	US\$ Mn.
Canada	1017
Mexico	284
Japan	224
Malaysia	2
Indonesia	4
Sri Lanka	0.1

Source : UN statistics

These figures show the significance of volume of rubber products that come to USA from Canada and Mexico. When NAFTA provisions are implemented this volume of trade will be doubled as the NAFTA rules are providing duty free entry of products into USA which facility will not be available for products from other nations.

Rubber sector as a one single sector is very important for Sri Lankan exports as well as industries. A number of industries that could be started using rubber as a raw material is very large and therefore the employment opportunities are also possible that other sectors such as tea. Hence any shrinkage of exports could affect the sector adversely.

There are two possibilities to defeat the unfriendly atmosphere that could be created as a result of NAFTA.

One is the enforcement of the GATT rules which were recently finalized in Morocco. The decisions taken at final session of GATT will not advocate any type of trade restrictions of this nature.

Secondly, is the growing demand for natural products in the USA and Europe due to enormous environmental problems these countries face with. For example, most of the consumers are replacing plastic or PVC items such as PVC mats *etc* with natural rubber mats which are bio-degradable. Therefore one can assume that the demand for natural rubber items would rise tremendously in the future and to satisfy such increased demand NAFTA members will have to increase the imports by relaxing restrictions.

6. Conclusion

When 360 million people from these countries (US, Canada and Mexico) form a free trade zone, it is almost impossible for the rest of the world not to take notice. This is specially so when one of the countries is a major economic super power, another is an aspiring newly industrializing economy and the other is a rapidly prospering economy. Basically, there are two possibilities for NAFTA to be:

(a) Protectionist trading bloc with new tariff to exclude foreign goods;

or

(b) a grouping that will bring about synergies not only for the three participating countries but also foreigners who can take advantage of one big North American market.

What ever the form NAFTA will actually take and any likely threats resulting out the agreement could be dealt with if Sri Lankan exporters adopt the following strategies.

1. Identification of more cost effective rubber products for promotion in the NAFTA Region.
2. Finding new markets specially for the rubber products which are likely to effect as a result of the implementation of NAFTA.

However, it can be inferred from the above discussion on the micro level issues that Sri Lanka is likely to maintain a share in the US market despite the changes until such time US finds reliable suppliers at comparative cost advantage to the US. However, it may be more optimistic to believe that US will not strain her trade relaxations with regular trading partners in the short run as a result of the formation of NAFTA. This in turn gives the Sri Lankan exporters a lead time of at least 3-5 years for them to implement their strategies in order to overcome any difficulties resulting from NAFTA.

Finally it should be emphasized that trade, political measures, how important they may be, cannot by themselves lead to the desired success at micro level. Exporters will have to be made thoroughly aware of the fact that international marketing - compared with marketing in the local market is far more complex, because international business is confronted with a number of environmental differences over which he has no control.