

Indo-Lanka Trade Agreements: Performance and Prospects

Introduction

During the colonial era, the entire South-Asian subcontinent was a highly integrated trading area and intra-regional trade was substantial. However, after independence, intra-regional trade declined substantially as most developing economies adopted import substitution industrialisation policies. Accordingly, trade between Sri Lanka and India declined until 1991 when India undertook economic liberalisation policies. Trade between the two countries gradually increased, particularly Sri Lankan imports from India. Economic integration between Sri Lanka and India received a boost via the South-Asian regional trade agreement, SAPTA (South-Asian Preferential Trade Agreement). However, the SAPTA was very limited in terms of depth and breadth of liberalisation, and progress in liberalisation was undermined by political clashes between India and Pakistan over nuclear testing and Kashmir (Weerakoon and Thennakoon 2008). India and Sri Lanka, frustrated by lack of progress in the regional format of trade liberalisation, signed a bilateral free trade agreement in 1998. The Indo-Lanka Free Trade Agreement (ILFTA) commenced implementation in March 2000, and was scheduled to be fully implemented by 2008. Given the positive developments in the ILFTA,

the two countries decided to pursue greater economic integration. Based on the recommendations of the Joint Study Group appointed to study the prospects for greater economic integration, the two countries commenced negotiations for a Comprehensive Economic Partnership Agreement (CEPA) in February 2005. The negotiations reached an advanced stage in June 2008, and a framework agreement was due to be signed by the two Heads of States at the 15th SAARC Summit in Colombo, however, discontent among Sri Lankan stakeholders resulted in the negotiations coming to a halt and the CEPA remains in limbo at the time of writing. This article examines the performance of the ILFTA and the prospects for the CEPA between India and Sri Lanka.

Recent Trends in Indo-Lanka Economic Relations

Trade

Sri Lanka's trade with India changed dramatically following the implementation of the FTA in the year 2000. India fully implemented the Agreement by March 2003, and Sri Lanka did so by October 2008 as the latter had a longer time frame given economic asymmetries between the two countries. In the period immediately preceding the Agreement, 1995-2000, average annual exports from

Sri Lanka to India stood at US\$ 39 million whilst average annual imports were US\$ 509 million. India has been an important source of imports even prior to the Agreement coming into place; by the year 2000, India was already the second largest

Deshal de Mel

*Research Economist,
Institute of Policy Studies.*

source of imports to Sri Lanka after Japan. However, India was not a major export market prior to the ILFTA, and in the year 2000, it was in the 14th rank in the export destinations, with even the Maldives was importing more from Sri Lanka (Kelegama and Mukherji, 2007).

It is clear from Table 1 and Figure 1 that exports from Sri Lanka increased substantially since the agreement was implemented in 2000. By 2005, Sri Lanka's exports to India reached US\$ 566.4, a ten fold increase compared to 2000 in a five year period. It should be kept in mind, however, that this rapid growth is from a small base. The number of products exported by Sri Lanka to India has 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. 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 scrap steel, areca nuts, dried fruit, cloves and waste paper. By 2008, there were still a

Table 1
Values of trade between India and Sri Lanka from 1995 to 2008

Year	Exports (US\$ Mn)	Imports US\$ (Mn)
1995-1999 Average	39	509
2000	58.0	600.1
2001	72.0	601.5
2002	170.5	852.8
2003	245.3	1073.2
2004	391.5	1439.1
2005	566.4	1835.4
2006	489.5	2172.9
2007	515.3	2610.1
2008	418.3	3443

Source: Central Bank of Sri Lanka

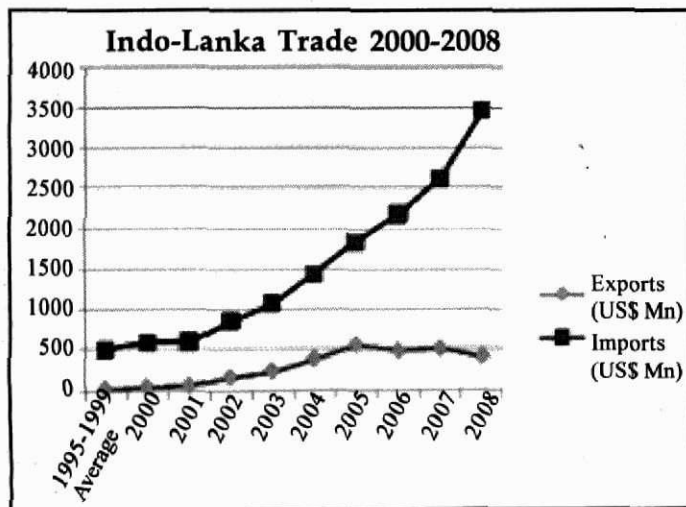


Figure 1: Trade between India and Sri Lanka 2000-2008

Source: Central Bank of Sri Lanka

number of primary products exported to India; however, several value-added products such as insulated wires and cables, pneumatic tyres, ceramics, vegetable fats and oils, refined copper products, rubber gloves, apparel, pharmaceutical products and furniture were among the top exports to India (Department of Commerce data). Imports too have grown at a rapid rate following the implementation of the FTA. In 2000, imports from India amounted to US\$ 600.1 million, whereas in 2008, imports had reached US\$ 3.443 billion, a growth by 5.7 fold. India is now Sri Lanka's main source for imports (Department of Commerce data).

Whilst total trade between the two countries has increased substantially, the absolute trade deficit has also increased. In the initial years following the implementation of the Agreement the ratio of imports to exports narrowed as exports from Sri Lanka grew at a faster rate than imports from India. However since 2005, the trend reversed again, driven largely by increasing oil prices (which made up almost a third of import value from India in 2008) and a fall in Sri Lankan exports to India, particularly vanaspathi and copper products. According to Figure 3, the import export ratio fell to 3.24:1 in 2005 from 10.34:1 in 2000, but increased again to 8.23:1 in 2008. In 2009, Sri Lanka would have fully liberalised trade with India (other than those items on the negative list) as items in the residual list were fully liberalised in October 2008. Therefore, it is possible that non-petroleum imports from India would grow at a faster rate in the coming years¹.

Investment

Indian investment into Sri Lanka has also increased substantially since the FTA came into operation. Between 1978 and 1995, Indian investment had contributed US\$ 5.2 million to a total foreign direct investment (FDI) stock of US\$ 426.6 million in Sri Lanka, amounting to 1.2 percent of total FDI (Weerakoon, 2008). However by the end of 2007, Indian investment in Sri Lanka contributed 6.5% to cumulative FDI stock. India contributed 16% to total FDI flows between 2001 and 2006 (Samarajeewa and Herath, 2008). The bulk of Indian investment in Sri Lanka in recent years has been in the services sector. Sixty three percent of cumulative Indian investment as of end 2007 was in services. Fabricated metal products and food processing products accounted for 10% each of cumulative Indian investment during this period. In the year 2000, the cumulative Indian investment in services was just 30% of total cumulative Indian investment, and 30% of investment was in beverages and tobacco and 14% in other manufactured products. Therefore, it is clear that Indian investment in Sri Lanka has taken on a more sophisticated nature, with recent investment being focused in sectors such as telecommunications (Bharti Airtel), health (Apollo Hospitals), retail services (Lanka India Oil Company), energy, hospitality (Taj Hotels) and air transport services (Jet Airways). As evident in Figure 4, as of the end of 2007, Indian investment has resulted in over 70 projects, employing 6747 individuals (Samarajeewa and Herath - 2008).

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 2007 was influenced by the increased profile of economic ties between the two countries and increased investor confidence as a result of the FTA.

Services

Investment in the services sector is just one way in which trade in services between India and Sri Lanka has expanded substantially in recent years. Monetary measurement of trade in services is very limited, and therefore, exact figures of trade in services are difficult to be calculated. 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 trans-shipment earnings from the Indian subcontinent (Taneja et al, 2004), approximately 40% of Sri Lankan airlines' revenue is from the Indian market (SriLankan Airlines) while Indian airlines, Jetwing and Kingfisher have operations in Sri Lanka. Sri Lankan information technology firms have provided technical solutions to Indian companies (Interblocks sold internet banking solution to Indian banks and Microimage sold TamilSMS adaptation to Bharti Airtel) and Sri Lankan tourist sector firms such as Aitken Spence and Jetwing have also ventured into the Indian market (De Mel, 2008). Several

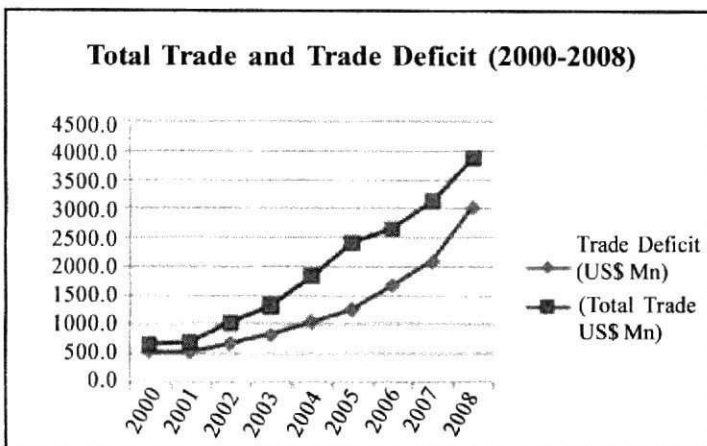


Figure 2: Total trade and trade deficit between Sri Lanka and India from 2000 to 2008

Source: Central Bank of Sri Lanka

Whilst the dominance of services

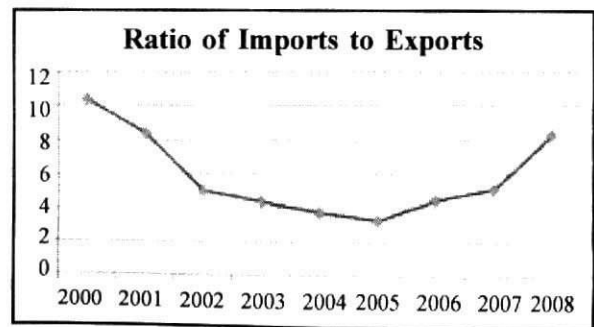


Figure 3: Import-Export ratios between Sri Lanka and India

Source: Central Bank of Sri Lanka

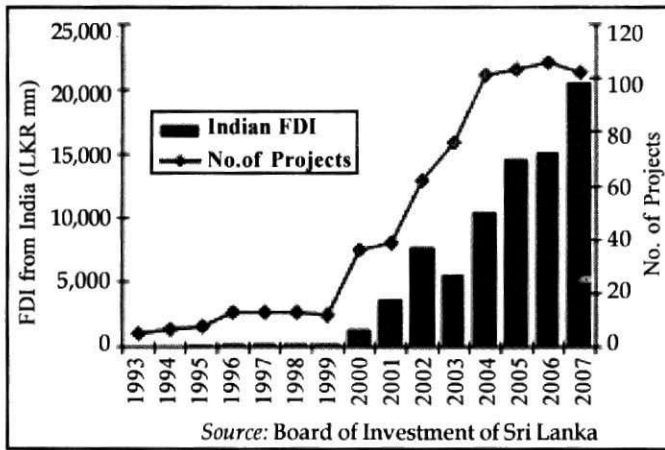


Figure 4: Indian investment in Sri Lanka 1993-2007
Source: Samarajiva and Herath (2008)

Indian firms have invested in Sri Lanka to supply services, including Apollo Hospital, ICICI Bank, Bharti Airtel, Taj Hotels and Indian Oil Company. India has become the largest source of tourists to Sri Lanka accounting for 19.4% of the market share in 2008 (Sri Lanka Tourism Development Authority data).

Impact of the ILFTA

An aggregate view of trade between India and Sri Lanka since the FTA came into place 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.

In 2005, exports from Sri Lanka to India peaked at US\$ 566.4 million (Central Bank of Sri Lanka, Annual Report). However at this peak, Sri Lanka's exports to India were largely concentrated in two products, copper and vanaspathi (A type of vegetable fat/oil that is made from refined palm oil). Table 2 shows that 49.66 % of Sri Lanka's export value was from the export of these two tariff lines. If

Table 2: Major Sri Lankan exports to India-2005

Product	Value in SL Rs.Mn.	%
Copper and Copper products	15,590	27.74
Vegetable fats and oil – Vanaspathi	12,321	21.92
Aluminium Products	4,534	8.07
Electrical Machinery and Parts	2,304	4.10
Antibiotics	2,279	4.06
Cloves	1,659	2.95
Iron & Steel Products	1,511	2.69
Pepper	1,088	1.94
Pulp	1,077	1.92
Fibre board of wood, etc.	1,034	1.84

Source: Department of Commerce, Sri Lanka

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 5 fold compared to the ten fold increase when including vanaspathi and copper. It is clear that the narrowing of the trade deficit between the two countries was largely due to these two product lines.

The concern with vanaspathi and copper is the fact that the export of these items arose 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. India maintained high tariffs on import of crude palm oil from countries such as Malaysia, whilst Sri Lanka maintained relatively low tariffs on the import of these products. Therefore, Indian investors set up vanaspathi manufacturing plants in Sri Lanka, imported crude palm oil, processed it in Sri Lanka to form vanaspathi (meeting the rules of origin requirements) and exported it to India free of duty under the ILFTA. The viability of the industry was only as long as there was a discrepancy between the Indian and Sri Lankan tariffs on palm oil imports. 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 then 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

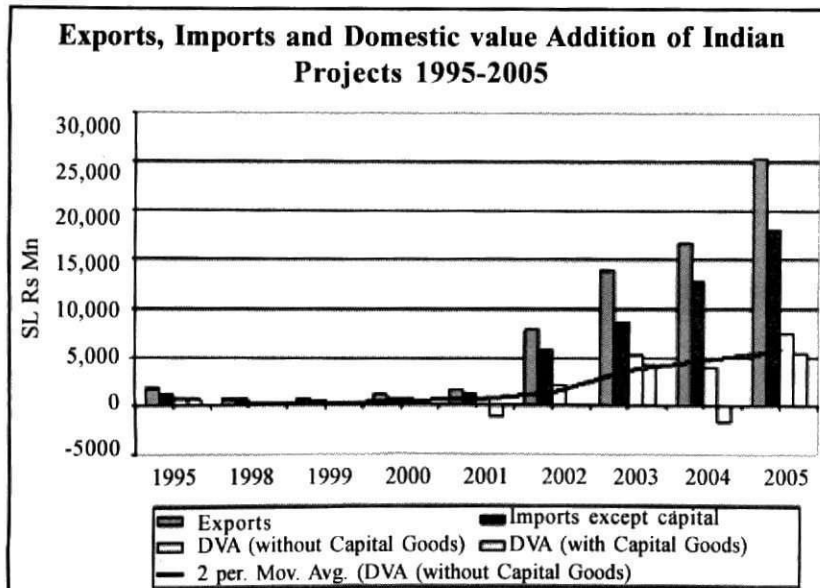


Figure 5: Indian investment projects: exports, imports and domestic value addition

Source: U. Wickramasinghe (2007), Indo-Lanka Free Trade Agreement: A Survey of Progress and Lessons for the Future, EU Sri Lanka Trade Development Project.

ineligible (Institute of Policy Studies 2008). Both copper and vanaspathi exports were not seen very favourably in Sri Lanka as well, given the fact that both entailed a high import content, limited employment creation (as shown in Figure 5) and environmental concerns associated with waste disposal.

However, 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\$ 21 million in 2007 (Department of Commerce of Sri Lanka data). In response to the increase in global commodity prices in 2007/2008, India slashed import taxes on various food imports including palm oil imports. On March 21st 2008, the Government of India slashed most favoured nation (MFN) import duties on crude palm oil and crude palm olein from 45% to 20% under customs notification 37/2008. Subsequently tariffs on crude palm oil imports were slashed completely (Department of Commerce of India), making vanaspathi exports from Sri Lanka all but completely unviable.

Unsurprisingly, vanaspathi exports in 2008 from Sri Lanka to India were LKR 4.5 billion, a fall of 72% from vanaspathi exports in 2007 which amounted to LKR 16 billion. Copper exports from Sri Lanka to India continued their decline in 2008 with total exports being LKR 1 billion compared to LKR 2.3 billion in 2007 (Ceylon Chamber of Commerce

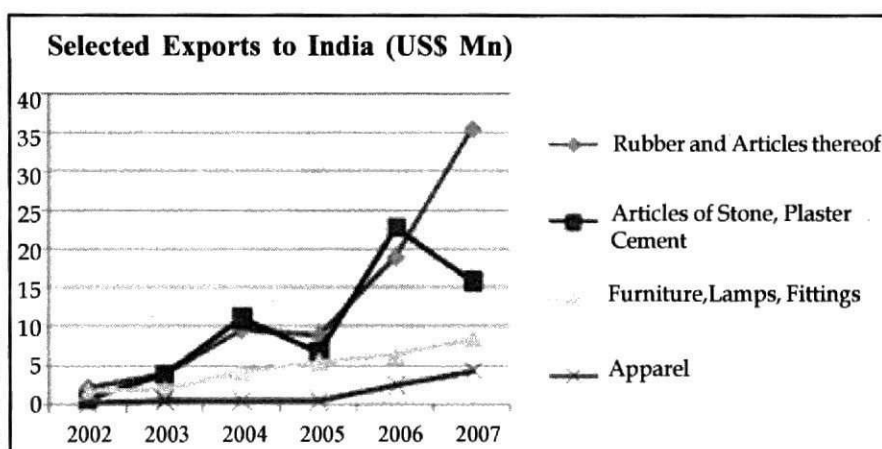


Figure 6: Selected exports to India (2002-2007)

Source: Customs

2009). 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 substantially in recent years. In 2008, imports from India reached a peak of US\$ 3.443 billion, a growth of 32% year on year since 2007 (Department of Commerce of Sri Lanka data). However, the major cause for the increase in imports from India was the increased cost of petroleum products in global markets (crude oil reached US\$ 148 a barrel in June 2008). 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 are not subject

to reduced tariffs 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 (see Table 3).

This analysis suggests that the growth of the trade deficit between India and Sri Lanka is not largely as 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 as seen above. A country need not be overly concerned about bilateral trade deficits, since these are simply a reflection of the industrial specialisation 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 United States (US) (and has large trade surpluses with these countries). It is more of a concern when there is a substantial overall (multilateral) current account deficit, which is symptomatic of misaligned macroeconomic fundamentals.

Furthermore, whilst, 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 which have been able to capture niches in the Indian market (see Figure 6).

Critics of the ILFTA, however, have argued that there are inherent weaknesses in the Agreement that make

Table 3: FTA treatment of top 10 imports from India in 2008

HS Code	Product	Status
27	Petroleum	Negative List
87	Vehicles and Parts	Negative List
17019901	Sugar	Negative List
52	Cotton	MFN Duty Free
72	Iron and Steel	Negative List
30	Pharmaceutical Products	MFN (0 - 2.5) duty
48	Paper and paper board	Negative List
740811	Copper wire	ILFTA duty free
230400	Oilcake and other solid residues	ILFTA residual list (70% duty waiver) until 7 th November 2008, since then duty free.

Source: Ceylon Chamber of Commerce Trade Newsletter (top ten imports from India) and Department of Commerce (negative lists).

it very challenging for Sri Lankan exporters to compete in the Indian market. Many of these contentions have been addressed in subsequent negotiations between the two parties during the course of negotiations for the Indo-Lanka Comprehensive Economic Partnership Agreement (CEPA), such as restrictions on ports of entry and quotas on the export of certain products from Sri Lanka to India. Garment exports from Sri Lanka were initially restricted in terms of both quantity and rules of origin. The initial agreement enabled Sri Lanka to export 8 million pieces annually at a 50% margin of preference, with the condition that 6 million pieces will only receive the concession, if it uses Indian textiles (Department of Commerce of Sri Lanka). This inhibited exports of garments and quota utilisation was less than 1% (Kelegama and Mukherji 2007). Sri Lanka's other major export, tea, was also restricted to a quota of 15 million kg annually, and would receive a preferential tariff of 7.5% with port restrictions to Cochin and Kolkata (Department of Commerce of Sri Lanka). As a result, there was just 2.7% quota utilisation by Sri Lankan tea exporters (Kelegama & Mukherji 2007). However, as part of the negotiations of the CEPA, these issues were also discussed, and the port restrictions on tea export were removed in June 2007, and 3 million garments were allowed duty free without sourcing requirements. As a result, garment exports from Sri Lanka to India have increased from US\$ 0.156 million in 2002 to US\$ 4.194 million in 2007 (Department of Commerce of Sri Lanka).

Other concerns such as state tariffs and other opaque levies over and above the published tariffs also remain. Being a federal government, India's different states apply various taxes over and above the national tariffs. Such State taxes, in Tamil Nadu in particular, have had an adverse impact on Sri Lankan exports. Local producers in Tamil Nadu pay a state tax of 10.5% whereas products from other Indian states and other countries pay a tax of 21% (Kelegama and Mukherji 2007). The argument put forward by India is that Sri Lanka continues to have an advantage over other countries. Nonetheless, considering the fact that Tamil Nadu has a population thrice that

of Sri Lanka, the state taxes make it very difficult for Sri Lankan exporters to compete in this key market in India. Anecdotal evidence also suggests that delays at customs and bureaucratic red tapes continue to hinder export penetration from Sri Lanka to India.

Comprehensive Economic Partnership Agreement

The ILFTA has had both positive and negative effects during its first 9 years of implementation. Given the early success of the Agreement, both parties were 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 liberalisation 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 heads 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 shelved 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 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 as a move towards free movement of labour between the two countries. Critics failed to take into account the fact that like the FTA, the CEPA held at its foundation the economic asymmetry between the two countries, and therefore accorded special and differential treatment to Sri Lanka. Whilst India had 419 items on its negative list in the FTA, Sri Lanka maintained 1180 items on the negative list which would not be subject to trade liberalisation. This included the entirety of the agricultural sector and key revenue items such as motor

vehicles. In the CEPA services agreement too, Sri Lanka was not expected to fully reciprocate India's commitments. Furthermore, the CEPA services agreement was based on a positive list framework. Accordingly, the two countries exchange request lists for the liberalisation of a specific sector, and each country can choose to make an offer which is in line with their comfort levels and developmental interests. As a result, there is a great deal of flexibility in the liberalisation of trade in services. This allowed Sri Lanka to subject to liberalisation only the sectors and sub-sectors that it felt were in its own interest to liberalise. Accordingly, Sri Lanka's draft offers to India were well below what was already liberalised through Sri Lanka's unilateral regime.

Given these flexibilities, concerns about a "flood" of Indian labour were completely misplaced (De Mel 2008). In the draft offers, Sri Lanka only offered temporary, contract basis market access to Indian labour in two sectors - for expert trainers in information technology and in five categories of workers in repair and maintenance of sea-going vessels where there were shortages in the domestic market, inhibiting effective delivery of services. There was no access given to Indian labour in any other sector. Even in these two sectors, any prospective employee must conform to immigration laws, regulatory standards and obtain the necessary work permit, based on an employment contract with a Sri Lankan employer.

The second concern, that the shortcomings in the FTA should be addressed before CEPA, will be counterproductive since CEPA provides the forum through which these shortcomings could be addressed. In fact, it was during the CEPA negotiations that many of the early problems with the FTA were addressed, such as the removal of port restrictions and rules of origin requirements in garments. With the CEPA negotiations being shelved, the only forum for addressing shortcomings of the FTA has closed. The CEPA was to include a clause that ensured bi-annual Trade Secretary-level meetings to address any teething problems in the CEPA and FTA. Furthermore, delaying CEPA until

all the issues in the FTA were addressed would delay the implementation of CEPA substantially, and would result in the hi-jacking of the interests of trade in services and investment, and hold up the benefits of liberalisation of these sectors.

Conclusion

The Indo-Lanka FTA and the proposed Comprehensive Economic Partnership Agreement between the two countries have come under criticism in Sri Lanka, largely due to concerns about the substantial asymmetries in development and size of the two nations. However, given the fact of geographic proximity, 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 market, with 60.3% of exports going to the US and European (EU) markets, diversification of export markets becomes essential. This necessity was 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 India (7.3%) and China (9%) have managed to sustain some degree of economic growth despite the global downturn. Had Sri Lanka maintained a more diverse export basket, the country would have been less vulnerable to external shocks. Trade agreements such as the ILFTA have somewhat helped shift Sri Lanka's trade towards alternative emerging markets by encouraging exporters to move beyond

their traditional buyers. In the medium to long term, this strategy will be essential given the fact that world trade can no longer rely on the unsustainable credit-based consumption booms, particularly in the United States. The global imbalances (production and savings by East Asia and the Middle East along with credit-based consumption in the 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 of the shift in global economic powers towards the east.

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), in a trade relationship defined by anarchy, the more powerful country (in this case India), will dominate and be able to dictate terms. Such a situation is always inferior to a managed trade relationship with defined rules, even if these rules are imperfect. Given this backdrop, the continued failure to proceed with the CEPA is unfortunate and detrimental to Sri Lanka's trade policy.

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Footnote:

¹ Growth of Indian imports in 2009 is likely to be stemmed by an overall economic slow down in Sri Lanka and the rest of the world which has resulted in a decline in imports into Sri Lanka. Motor vehicle imports from India are likely to be the most affected by this as overall motor vehicle imports have contracted in 2009 – though there is some possibility of substitution towards Indian vehicles as relatively cheaper alternatives in a time of economic slow down.