

## Chapter 23

# India–Sri Lanka Free Trade Agreement and the Proposed Comprehensive Economic Partnership Agreement: A Closer Look

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### 23.1 Introduction

In pre-colonial times there were strong economic relations between India and Sri Lanka, but these relations diluted during nearly four and a half centuries of colonial rule. Soon after independence in both countries, economic relations strengthened, but not significantly, as a result of inward-looking economic policies dominating in both economies until about the mid-1980s. The economic links began to pick up in the 1990s with the liberal economic regimes consolidating in both economies, and received a boost in 1998 when the two countries signed a bilateral India–Sri Lanka Free Trade Agreement (ISLFTA), which came into operation in March 2000. This was a pioneering attempt in the direction of trade liberalisation in the South Asian region and involved the liberalisation 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 ISLFTA was formulated based on the 'negative list' approach; each country extending tariff concessions/preferences to all commodities except those indicated in its negative list.<sup>2</sup> The two countries agreed for preferential treatment on 5,112 tariff lines.

Over the years much research has been done on how to design a free trade agreement (FTA) between a small and large country to work as a 'win-win' situation. This is done by taking the asymmetry between the two countries into account and building special and differential treatment (SDT) for the smaller country into the FTA, with the large country not insisting on reciprocity by the smaller country. SDT was built into the ISLFTA in favour of Sri Lanka with a longer negative list, longer trade liberalisation schedule, favourable rules of origin, and so on.<sup>3</sup>

This chapter provides a broad brush Sri Lankan perspective of the current situation vis-à-vis India–Sri Lanka trade and investment, while highlighting some of the findings of in-depth studies done on the FTA so far. The chapter goes on to highlight the impediments faced and various constraints that have prevented the FTA moving to the higher stage of a Comprehensive Economic Partnership Agreement (CEPA). It also highlights the opportunities of a CEPA through which Sri Lanka can gain, especially at a time when its traditional export markets are undergoing a recession.

## 23.2 Experience of the ISLFTA: Recent trends

### 23.2.1 Trade in foods

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 (close to 1 per cent of Sri Lanka's overall exports) while average imports were US\$509 million (close to 10 per cent of Sri Lanka's overall imports). While India was an important source of imports even prior to the FTA, it was not a major export market, and in 2000 it ranked 14th in terms of India's export destinations. By 2005, Sri Lanka's exports to India reached US\$566.4, a ten-fold increase compared with 2000, and stood at US\$567 million in 2012 (see Table 23.1). India was the fifth largest destination for Sri Lanka's exports in 2008 and by 2012 India has become the third largest export destination after the EU and the USA.

The number of products exported by Sri Lanka to India also increased substantially during this time. While in 1999 Sri Lanka exported 505 tariff lines to India, by 2005 this had increased to 1,062, and by 2012 had further increased to 2,100. In the early years of the FTA there had been trade creation with a number of new products exported from both countries (Mukerjhi et al. 2003). The ISLFTA did not become a discriminatory trading framework for the rest of the world and according to Joshi (2010) it had a trade-creation effect on the rest of the world.

Sri Lanka gradually 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

**Table 23.1 India–Sri Lanka merchandise trade: 2000–12**

Year	Sri Lanka				
	Exports to India (US\$ million)	Imports from India (US\$ million)	Share of total exports (%)	Share of total imports (%)	Import:export ratio
2000	58	600	1.0	9.0	10.3:1
2001	72	601	1.5	10.5	8.4:1
2002	170	832	3.6	13.8	5.0:1
2003	245	1076	4.6	16.1	4.4:1
2004	391	1439	6.8	18.0	3.7:1
2005	566	1835	8.9	20.7	3.2:1
2006	489	2173	7.1	21.2	4.4:1
2007	515	2610	6.7	23.1	5.1:1
2008	418	3447	5.2	24.5	8.2:1
2009	322	1820	4.5	17.8	5.7:1
2010	474	2570	5.6	19.0	5.4:1
2011	519	4431	4.9	21.9	8.5:1
2012	567	3640	5.8	19.0	6.4:1

**Source:** Central Bank of Sri Lanka, (2008), *Annual Report*, various issues

a 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 and furniture were among the top exports to India.<sup>4</sup> Imports too grew at a rapid rate following the implementation of the FTA. Imports from India, which amounted to US\$600.1 million in 2000, reached US\$3.64 billion in 2012, six-fold growth. 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 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 was a positive development.

There were, however, some unfavourable trends in Sri Lanka's exports to India during 2005–07. Although exports from Sri Lanka to India reached a high value of US\$566.4 million in 2005, these exports were largely concentrated in two products – copper and vanaspathi (a vegetable oil) – with 49.66 per cent of Sri Lanka's export to India being from the export of these two tariff lines. 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 2005, an increase of five-fold compared with the ten-fold increase with vanaspathi and copper. Why did these two industries dominate during a brief period in the mid-2000s?

### 23.2.2 Vanaspathi and copper boom

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.<sup>5</sup> The vanaspathi industry was viable only as long as there was a difference between the Indian and Sri Lankan tariffs on palm oil imports – the main input ingredient of vanaspathi. In Sri Lanka there was a duty-free importation facility for palm oil for industrialists listed under the Board of Investment, in addition to a duty-free exporting facility to India, while in India a tariff close to 60 per cent was applied to the importation of palm oil. In response to the increase in global commodity prices in 2007/2008, India cut import tariffs 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 per cent from exports in 2007 which amounted to LKR 16 billion. Vanaspathi exports had completely disappeared by 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 and violated the rules of origin criteria. India insisted that pricing of iron ore inputs for copper should be carried out based on the London Metal Exchange Prices, and since adhering to this rule a large proportion of Sri Lankan copper exports were deemed ineligible to the Indian market (IPS 2008). With the change in invoicing measures, copper exports from Sri Lanka were the first to be affected, with exports falling from US\$145 million in 2005 to US\$13 million in 2008.

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 per cent fall in export value since the peak in 2005. In 2009, due to the global financial crisis, exports to India further fell to US\$322 million and then recovered gradually until they reached closer to the 2005 level of exports by 2012. In short, the vansapathi/copper episode and the global financial crisis dipped Sri Lankan exports to India for nearly seven years from 2005.

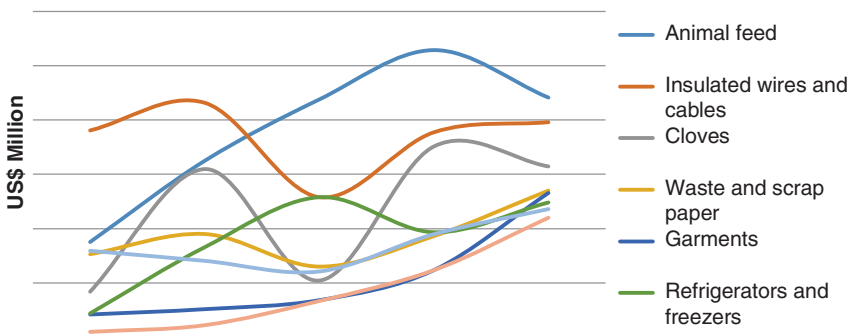
### 23.2.3 Increased value-added exports

As stated, since 2008 there has been rapid growth in exports of high-value-added manufacturing goods to India, and by 2011 insulated wires and cables, garments, animal feed, refrigerators and freezers were prominent exports (Figure 23.1). Moreover, value-added tea, furniture, tableware, machinery, rubber gloves and refined copper products were able to capture niches in the Indian market. Over 70 per cent of Sri Lankan exports to India went under the FTA during the post-2007 period, and in 2011 the share was 83 per cent.

At the same time, imports from India have increased considerably. In 2008, imports from India reached US\$3.44 billion, a growth of 37 per cent compared with 2007. However, the major cause for the increase in imports was the increased cost of petroleum products in global markets.<sup>6</sup> 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 tariffs through the FTA, as over 70 per cent 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 per cent of the country's total imports from India in 2007 and 13 per cent in 2011.

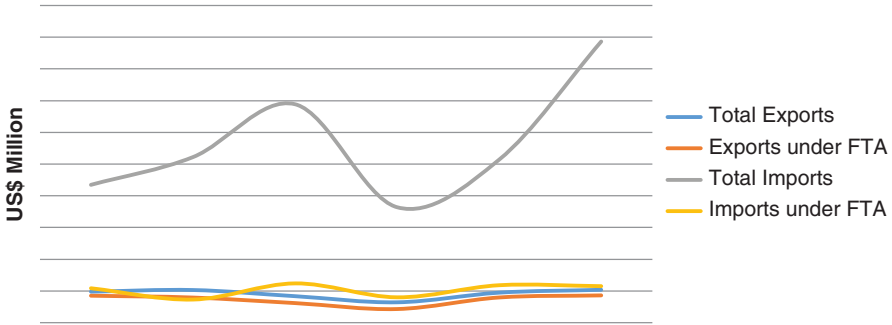
These observations suggest that the growth of the trade deficit between India and Sri Lanka is not largely a result of the FTA between the two countries, since most of the major traded items are not subject to the FTA. Figure 23.2 clearly shows that that

**Figure 23.1 Top exports from Sri Lanka to India, 2007–2011**



**Source:** Export Development Board of Sri Lanka, Export Performance Indicators

**Figure 23.2 Sri Lanka’s Trade under the FTA with India, 2006–11**



**Sources:** Central Bank of Sri Lanka, Annual Report, various issues and Department of Commerce of Sri Lanka, 2012

there is hardly a deficit between the two countries for actual goods moving under 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.

The trade deficit between the two countries could be viewed from the import–export ratio and, as clearly seen in Table 23.1, this ratio improved from 10.3:1 in 2000 to 6.4:1 in 2012, indicating that the overall deficit too has improved in favour of Sri Lanka. In fact, if the exceptional year of the vanaspathi and copper boom of 2005 is examined, the table clearly shows that the ratio had reached a peak level in favour of Sri Lanka to 3.2:1.

It must be noted that a country need not be overly concerned about bilateral trade deficits. Given the nature of globalisation 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 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 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.

**23.2.4 Investment**

There have been three waves of Indian investments in Sri Lanka after the opening up of the Sri Lankan economy in 1977. The first wave saw companies such as Ashok Leyland coming in 1982 to manufacture buses for the domestic market. After the 1983 political turbulence there was hardly any Indian investment. The second wave of investment started in the mid-1990s after India became the largest source of imports to Sri Lanka. Investments were seen in areas such as steel, cement, roofing sheets, and paint manufacturing. The third wave was seen after the FTA in 2000 and many of the popular companies, such as ICICI bank, Bharat Airtel, IOC, Apollo Hospitals, etc., starting to come to Sri Lanka. Indian investment amounted to 14 per cent of total FDI

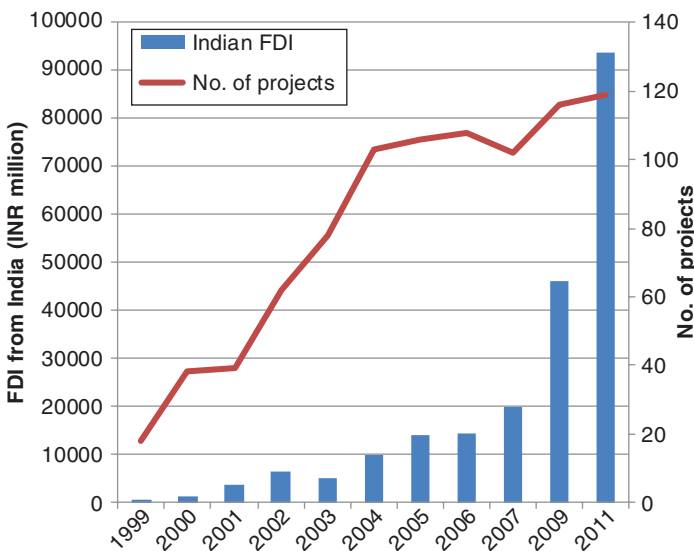
flows to Sri Lanka in 2008. India is now the second biggest investor in the country, exceeded only by Malaysia.

Indian cumulative investment in Sri Lanka is above US\$1 billion and Indian companies have committed to nearly US\$2 billion of investments in Sri Lanka for five years. Figure 23.3 shows the increasing Indian investment in Sri Lanka. The bulk of the existing Indian investment in Sri Lanka is in services such as telecommunications – Bharat Airtel, energy – Indian Oil Corporation, banking – ICICI Bank, tourism – Taj Hotels, etc., amounting to nearly 60 per cent of Indian investment. India is the main destination for Sri Lankan foreign investment and companies such as Carson Cumberbatch, Brandix (US\$1 billion worth of textiles and apparel city in Vizag), MAS Holdings, John Keells, Hayleys, Aitken Spence, Damro, Dankotuwa Porcelain, Ceylon Biscuits and Atlas Stationery are some of the companies that already have investments in India.

In the mid-2000s, 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 Board of Investment, by 2008, 5,900 jobs were created as a result of Indian investment. But this includes 1,500 employees in the Indian Oil Company retail outlets, which entailed rehiring staff from the Ceylon Petroleum Corporation-owned outlets rather than the creation of new jobs.

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 2012 was influenced by the increased profile of economic ties between the two countries and increased investor confidence as a result of the FTA.

**Figure 23.3 Cumulative FDI from India to Sri Lanka: 1999–2011**



### 23.2.5 Services

Monetary measurement of trade in services is very limited (due to the intangible nature of services) and, therefore, exact figures for 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 per cent of the Colombo port’s income is from transshipment earnings from India, and approximately 40 per cent of Sri Lanka Airlines’ revenue is from the Indian market, while Indian airlines, Jet and Spicejet (and sometime back Kingfisher) have operations in Sri Lanka. Sri Lankan information technology firms have provided technical solutions to Indian companies.

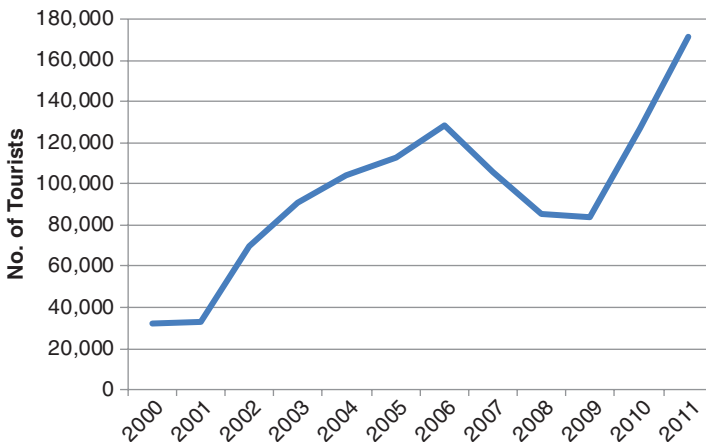
Sri Lankan tourist sector firms such as Aitken Spence and Jetwing have also ventured into the Indian market. India has become the largest source of tourists to Sri Lanka. India now accounts for 20 per cent of tourist arrivals to Sri Lanka. Figure 23.4 shows the increasing trend of Indian tourist flows to Sri Lanka. Improved bilateral relations, including unilateral visa liberalisation by Sri Lanka contributed to the rapid growth of Indian arrivals. Meanwhile, Sri Lanka is among the top five countries that supply tourists to India. Buddhist pilgrims’ travel to India has increased due to better connectivity and the availability of a budget airline in Sri Lanka.

### 23.2.6 Problematic areas

While the aggregate figures resulting from the ISLFTA are impressive, the full potential of the FTA has not been reaped by Sri Lanka. 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 ISLFTA? Several reasons have been identified.

First, intra-industry trade between the two countries did not grow significantly enough to stimulate overall trade. Abeyratne (2013) finds that Sri Lankan

**Figure 23.4 Tourist arrivals from India to Sri Lanka: 2000–11**



Source: Central Bank of Sri Lanka, Annual Report, various issues

manufacturers have not been successful in linking up with Indian supply chains and this supports the earlier findings of de Mel and Jayaratne (2012) that vertical integration of Sri Lankan industries with Indian industries is at a very low level. The explanation for this could be found in the level of industrialisation in India compared with that of the ASEAN region. Abeyratne (2013) argues that the level of industrialisation is not sufficiently sophisticated to encourage large-scale supply chains to develop with regional suppliers. It may be noted in this context that India made a shift from agriculture to industrialisation, but before the level of industrialisation deepened, India made a rapid shift towards the service sector, surpassing the shift to services of many other developing countries.

Second, there were a number of impediments for market access in the Indian market. Some of them are highlighted here.

- Tariff rate quotas on major exports

Tea, and ready-made garments and textiles, which make up 50 per cent of Sri Lanka's total exports, were placed under quotas in the ISLFTA. Also, quota utilisation has been minimal due to stringent RoO requirements and port restrictions. Quota utilisation has somewhat improved following a degree of relaxation of RoO and port restrictions in 2007.<sup>7</sup>

Sri Lankan ready-made garment exports to India were negligible even after the FTA. Ready-made garments were granted preferential market access of 50 per cent for 8 million pieces per year, while textiles were granted a preferential margin of 25 per cent with no quantitative restrictions. Out of the 8 million pieces, 3 million were required to have Indian fabrics as per the rules of origin. While this condition remained till the end of 2012, the 8 million pieces were made duty-free in 2006. The quota utilisation for the 5 million pieces was 10 per cent to 15 per cent, while for the 3 million pieces it was 100 per cent, as Sri Lankan ready-made garment exports with Indian fabrics were not competitive in the Indian market. In 2013, the Indian fabrics usage conditionality was completely removed.

- 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 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 per cent while local products are taxed at 10.5 per cent on sales (Kelegama and Mukherji 2007).

- Rules of origin

Besides the stringent rules of origin within the tariff rate quotas (TRQs) for ready-made garments, the more general case of requiring a change in tariff heading (CTH) at the Harmonized System (HS) four-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 HS four-digit level is difficult to achieve even when blended with Indian tea.

- Unilateral imposition of quotas

Following the surge of vanaspathi imports from Sri Lanka to India, the two countries entered into negotiations in 2006 to apply a quota on vanaspathi exports as a result of the disruptions caused to the Indian domestic industry. The two countries initially agreed to a quota of 250,000 metric tonnes per year. However, in 2006 India unilaterally reduced this quota to 100,000 metric tonnes and canalised all vanaspathi imports from Sri Lanka through national procurement agency.<sup>8</sup> Further negotiations took place and the quota was reverted to 250,000 metric tonnes. 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 FTA as a whole due to strong unilateral measures.

A ‘back of the envelope’ calculation shows that if all exports of Sri Lanka go to India it would have amounted to 2 per cent of India’s overall imports; and in this context, India removing more of the NTBs to Sri Lankan exports should not be an issue. However, given the concentration of production and the federal state structure in India, the issue of restriction removal becomes more complicated. For instance, the state of Kerala accounts for 92 per cent of Indian pepper exports, 74 per cent of cardamom and 63 per cent of ginger, among others; it also accounts for 67.5 per cent of total spice exports from India (Ahmed and Jena 2012). It is reported that ISLFTA contributed to the depression of pepper prices in the Kerala market that led to a lot of ‘hue and cry’ among local producers in Kerala. In 2006, the Indian Pepper Spices Trade Association pressured the central government to impose quota restrictions on Sri Lankan pepper imports.<sup>9</sup> Accordingly, the central government imposed an annual import cap of 2,500 tonnes on Sri Lankan pepper imports and designated one port – Kochi – for such imports in order to monitor quantity and quality of such imports as there were allegations that third country pepper was coming to India via Sri Lanka through the FTA.

### 23.3 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, were keen on deepening and broadening the FTA, and based on the recommendations of the Joint Study Group (JSG) of 2003 report, it was decided to include trade in services, investment and economic co-operation, along with further liberalisation of the goods sector, under the ambit of a Comprehensive Economic Partnership Agreement (CEPA) (JSG 2003). 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 in parallel to the Fifteenth SAARC Summit in Colombo in July 2008. However, owing to the reservations expressed by a group of local industrialists with strong connections with the government 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 the 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 (General Agreement on Tariffs and Trade (GATT) Mode 4) which was understood as a move towards free movement of labour between the two countries. But 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 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. Moreover, GATT Mode 4 was linked to GATT Mode 3 and there was no standalone GATT Mode 4 liberalisation unless there was a special request by a particular sector in Sri Lanka. In the stakeholder consultations, such requests were made for ship repairing and the IT sector in Sri Lanka. Given such flexibility, concerns about a flood of Indian labour into the Sri Lankan market were completely misplaced.

The second concern, that the shortcomings in the FTA should be addressed before CEPA, is made with very little understanding of the Agreement. At the onset of discussions on CEPA, it was recognised that in the modern world trade in goods and services are inter-related and also closely linked to investment. Given these inter-linkages, the negotiation teams of both countries were of the view that all barriers for economic integration between the countries should be addressed in a broader framework that consisted of trade in goods, services and investment. Both mutual recognition agreements and memorandums of understanding (MoUs) were to be signed covering broad subject areas. Thus CEPA was negotiated with the very objective of addressing the shortcomings in the FTA, such as the removal of port restrictions, NTBs, RoO requirements in ready-made garments, and so on.<sup>10</sup>

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. The current limitations on established export items due to the global economic crisis 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 build up.

There are many successful Sri Lankan exporters to India, as was clearly seen from the increase in the number of products exported from Sri Lanka to India. However, many of these successful exporters are reluctant to come out in support of the CEPA for a number of reasons. For example, a successful strawberry exporter from Sri Lanka to

India says that his main problem is inadequate domestic supplies and not NTBs in the Indian market, and that he would not like to come out and openly support the CEPA as he fears that his rivals will eat into his market share in the Indian market.

In the entire CEPA criticisms in Sri Lanka, the NTBs in the Indian market have been highlighted time and again. However, it would not be prudent to over emphasise NTBs in the Indian market without looking at the overall bigger picture. The question could be posed as to how Chinese exports to India increased from a mere US\$1.5 billion in 2001 to over US\$50 billion by 2011 despite the existence of these same NTBs in the Indian market and without the benefit of an FTA? While this question needs detailed study, it is clear that NTBs alone do not explain the problem facing Sri Lankan exporters in capturing a bigger share of the Indian market. A factor that clearly stands out from this example is that Sri Lanka does not possess the supply capacity of China to fully exploit the growing Indian market. One way of addressing this issue is by promoting joint investment ventures with Indian companies with buy-back arrangements like, for example, CEAT–Kelani tyres which exports tyres produced in Sri Lanka to India among other countries.

For large Indian companies to be engaged in such ventures, Board of Investment incentives alone would not be adequate. There is a need to create a ruled-based investment regime with renewed double taxation agreements, investment protection agreements, pre-establishment national treatment, and so on. The FTA matured enough for these to be built-in as Sri Lankan investors have been moving increasingly to the Indian market and these investors will be more secured under a rule-based system.

With the CEPA negotiations being stopped, the only forum for addressing shortcomings of the FTA has been closed. Delaying CEPA until all the issues in the FTA are addressed would result in the hijacking the potential national gains by vested interests and hold up the benefits of liberalisation 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 (the USA and the EU) and products (ready-made garments and tea), diversification becomes essential. This necessity has been highlighted in the 2008 global economic crisis, as Sri Lanka became particularly vulnerable given the concentration of exports to the most adversely affected markets. Whilst the USA and EU markets have faced a recession, emerging markets such as India and China have managed to sustain some degree of economic growth despite the global downturn. The Indian economy has been growing at an average of around 7 per cent during 2009–2012. Had Sri Lanka maintained a more diverse export basket, the country would have been less vulnerable to external shocks by exploiting the neighbourhood markets, in particular, India.

The ISLFTA 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 unsustainable credit-based consumption booms,

particularly in the USA. 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 will no longer be viable, and increased domestic consumption in Asia and the Middle East will be required to re-balance the system. Given Sri Lanka's proximity with India, the country is in an ideal position to take advantage of this 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 and investment occur between the two countries. The lack of a rule-based regime to manage 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 transaction costs. For example, Sri Lanka has entered into bilateral and multilateral negotiations in the South Asian region such as the ISLFTA, PSLFTA (Pakistan-Sri Lanka FTA), SAFTA (South Asia FTA) and APTA (Asia Pacific Trade Agreement), each involving different rules of origins, tariff preferences, etc. In the absence of progress in regional frameworks such as APTA and SAFTA, the best option available to Sri Lanka is a bilateral framework within a rule-based disciplinary framework. Also, given the fact that India is currently engaged in negotiating a number of bilateral trade agreements with much larger economies, such as Japan and the EU, it would be unwise to delay the already-negotiated CEPA.

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 upper-middle-class individuals' incomes increase by 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 2008). 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 quite liberal – it is not a guaranteed position over time. 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. There is no better opportunity than the Indian market.

The experience of the 2008 global economic crisis has stressed the need for more inclusive and equitable trade and growth policies. The CEPA is important in this context, as an increased importing of services such as health and education from

India at a reasonably low cost through service sector liberalisation 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 USA, India is the only option for the poorer population.

### 23.4 Concluding remarks

The ISLFTA has now been in operation for 12 years. It has many achievements to its credit but is not free of problems. The potential of the FTA is yet to be fully exploited by Sri Lanka and, in this context, deepening and broadening the FTA is the way forward. Policy tools under the command of the respective governments need to be put into action to give more dynamism to the FTA and the trade–investment nexus is a very powerful component that could be used for this purpose. The causality from trade leading to investment is commonly seen, but the casualty the other way round of investment leading to trade, needs strengthening and this is what will stimulate intra-industry trade, supply chains, production networks, etc., and will further stimulate trade. This is what Sri Lanka must aim for beyond the FTA and where both countries could enhance the overall trading between the two countries from US\$5 billion to the target of US\$10 billion by 2016 as agreed by both governments in January 2013.<sup>11</sup>

In conclusion, the key opportunity is to tap into the large and dynamic Indian market, by moving beyond the ISLFTA 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. As an economic crisis grips Sri Lanka's traditional export markets and the global economy is experiencing a slow recovery, Sri Lanka should view India as an opportunity and not a threat, and strive towards more meaningful co-operation in facilitating sustainable development.

### Notes

- 1 Research assistance from Ashani Abeysekera, Research Officer, IPS, Colombo, in preparing this chapter is gratefully acknowledged.
- 2 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.
- 3 The immediate duty-free list (319 items) and 50 per cent preferential duty list (889 items) were considerably smaller than those offered by India (1,351 items and 2,799 items respectively), while the Sri Lankan negative list (1,180 items) was considerably larger than India's (196 items) (Kelegama and Mukherji 2007).
- 4 Department of Commerce, Sri Lanka website: [www.doc.gov.lk](http://www.doc.gov.lk)
- 5 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.
- 6 Crude oil reached US\$148 a barrel in June 2008.
- 7 India removed the port restrictions on tea imports from Sri Lanka within a quota of 12.5 million kg, (de Mel 2008).

- 8 See: [www.lankabusinessonline.com/news/Sri\\_Lanka-India\\_trade\\_talks\\_to\\_resume\\_control\\_of\\_vanaspati\\_exports\\_inconclusive/1450011840](http://www.lankabusinessonline.com/news/Sri_Lanka-India_trade_talks_to_resume_control_of_vanaspati_exports_inconclusive/1450011840)
- 9 In 1999, prior to the ISLFTA, India exported US\$69.025 worth of pepper (HS 0904.11) to Sri Lanka and with the FTA in place in 2005 pepper exports declined to US\$9,203 while pepper imports from Sri Lanka kept on rising.
- 10 Many of the misconceptions on CEPA have been addressed in Analyst (2008).
- 11 Target set at the meeting of the two external affairs ministers of both countries in January 2013.

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