

Indo – Sri Lanka Free Trade Agreement: A Critical Appraisal of the Influence on Trade Between the Two Countries

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Introduction

With the objective of expanding trade between the two countries, India and Sri Lanka entered into the Indo-Sri Lanka Free Trade Agreement (ISFTA) in 1998, which came into effect in 2000. A decade later, the question has arisen as to whether the Preferential Trade Agreement has benefitted the economies of the two nations, particularly from the Sri Lankan perspective. This question has become more pertinent in the midst of divergent opinions expressed on the possible implications of the Comprehensive Economic Partnership Programme (CEPA) which is being negotiated with a view to further broadening the framework of economic cooperation between the two countries.

An appraisal of the influence of the ISFTA on the evolution of Indo-Lanka trade has become the need of the hour. Even though a number of studies have already been conducted in this area², there appears to be no consensus among the researchers as to its effectiveness and impacts. The present study therefore, is an attempt to review the Agreement, through the analysis of Sri Lanka's trade with India and with the rest of the world, during the post ISFTA era, in comparison to the trade patterns in the pre Agreement period.

Data and Methodology

The study looked at the problem from a Sri Lankan view point, and analysed Sri Lanka's international trade data since 1994. The data, primarily sourced from the Sri Lanka Customs, were classified into ISFTA-neutral and ISFTA-favoured categories, and into imports from, and export to, India and the rest of the world. Trends were

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² De Mel, D. (2009), Kelegama, S. & Mukherji, I.N. (2007), Law and Society Trust (2010), Weerakoon, D. & Tennakoon, J. (2010) and Wickremasinghe, U. (2007)

analysed in volume (or “real”) terms in view of removing any price-based effects, and against the corresponding real GDP values to capture deviations from what is generally observed in association with the change of GDP. Such deviations were used as indicators of effectiveness of intervening conjunctures, including the coming into effect of ISFTA.

Results and Conclusions

The analytical results indicate that the Sri Lankan economy is becoming increasingly import intensive (from 17% prior to the year 2000 to almost 25% by 2010, in real terms, as a ratio of GDP). This trend invites attention of the policy makers, as it could have medium term Balance of Payments and external finance implications. The share of imports of Indian origin has grown significantly, from a mere 10% during the late 1990s to 23% by 2010. However, this growth of overall import intensity appears to have been driven mainly by the imports of Indian origin in the ISFTA-neutral category, and therefore cannot be identified as an effect of the ISFTA.

Figure 1 : Evolution of Sri Lanka’s Imports in relation to GDP

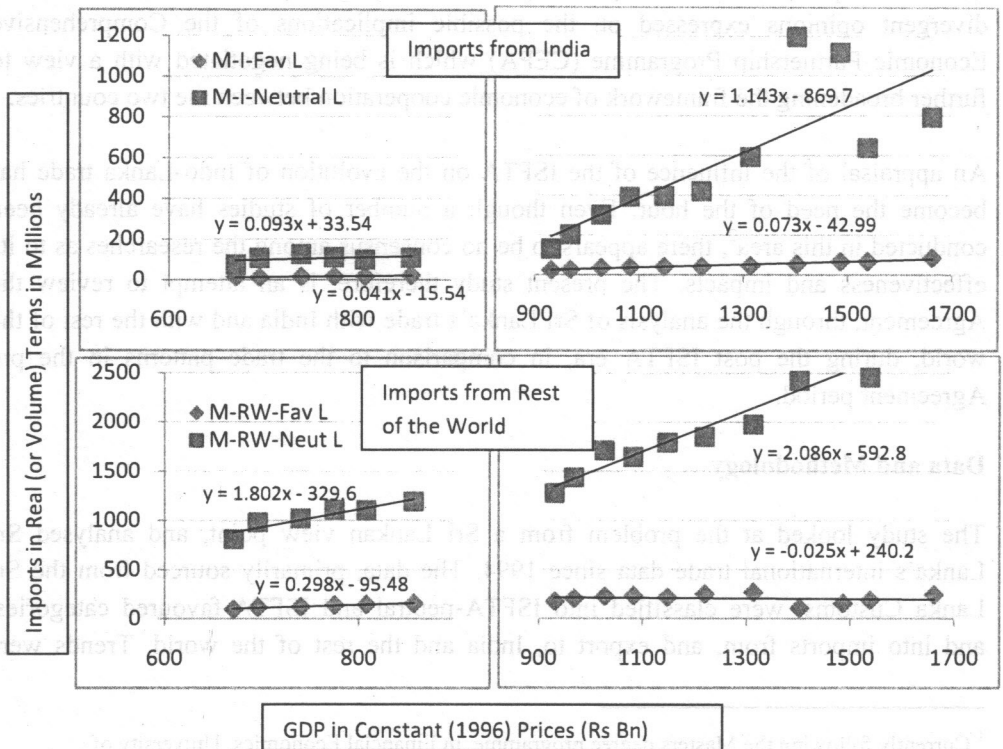


Figure 1 (above) presents the evolution of Sri Lanka's imports from India and from "rest of the world" in relation to GDP during pre and post ISFTA periods, and for ISFTA-favoured and ISFTA-neutral categories of imports³, while Table 1 summarises import intensities of Sri Lanka's GDP, worked out under the linearity assumption of trends.

Table 1 : Sri Lanka's Import Intensities of GDP 1994 -2010

| $\mu = D(M)/d(GDP)$ Origin | ISFTA-Neutral List | | ISFTA-Favoured List | |
|----------------------------------|--------------------------|---------------------------|--------------------------|---------------------------|
| | Pre-ISFTA (1994-1999) | Post-ISFTA (2000-2010) | Pre-ISFTA (1994-1999) | Post-ISFTA (2000-2010) |
| Imports from India | 0.09 (5%) | 1.14 (35%) | 0.04 (12%) | 0.073 (152%) |
| Imports from "Rest of the world" | 1.80 (95%) | 2.09 (65%) | 0.30 (88%) | -0.025 (-52%) |
| All Imports | 1.89 | 3.23 | 0.34 | 0.048 |

Source : Authors' Estimations

If trends pertaining to the ISFTA-neutral category reflect "relative competitiveness" of Indian exports to Sri Lanka as against those from the rest of the world, the above analysis leads to the conclusion that India has been able to outperform the rest of the world in both categories of products during the post-ISFTA period. However, the tangential deviation⁴ in the ISFTA-neutral category of imports from India has been much greater than that associated with the ISFTA-favoured category of imports (Table 2). This implies that the tariff advantages accorded to India in the ISFTA-favoured category of imports have not been effective in infusing the expected "supplementary momentum", over and above what could be attributable to her "competitive edge".

Table 2: Tangential deviations of Import Intensities of GDP with the implementation of the ISFTA

| Deviation of μ | ISFTA-Neutral Category | ISFTA-favoured Category |
|--------------------------------|------------------------|-------------------------|
| Imports of Indian Origin | + 0.95 | + 0.03 |
| Imports from Rest of the World | + 0.06 | - 0.33 |

Source : Authors' Estimations

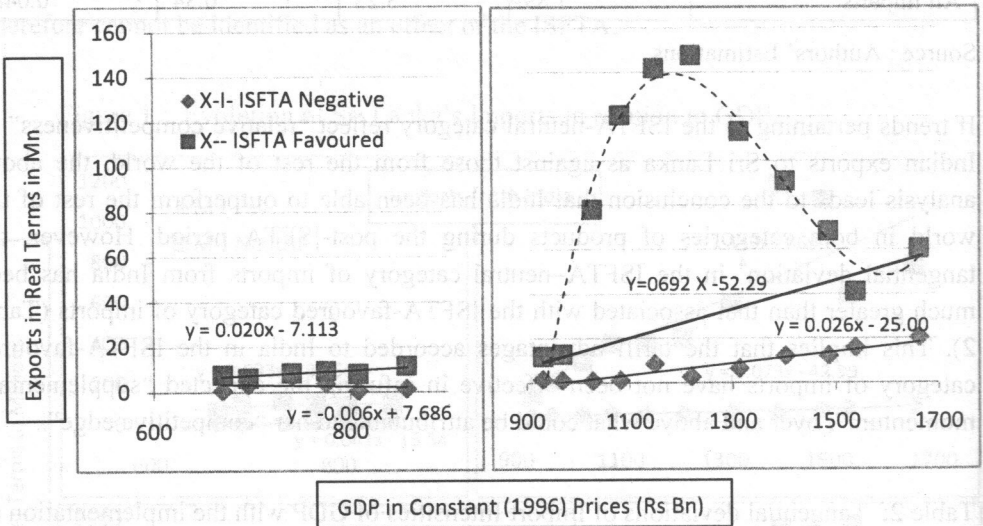
³ The "ISFTA-Neutral" category of imports to Sri Lanka includes both ISFTA "Negative List" items as well as those with "Zero Duty", for which items, there is no distinction between India and the rest of the world in terms of duty structure.

⁴ Tangent of the Angle of Deviation = $(m_2 - m_1)/(1+m_1m_2)$

The above tangential deviations also indicate that, with regard to the ISFTA-favoured category, the “rest of the world” has not been able to maintain the “positive shift” of import intensity it managed in the ISFTA-neutral category. Despite the apparently weak overall shift of import intensity in this category, the positive deviation of imports from India and the negative deviation in the “rest of the world” category, could possibly suggest a “trade diversion effect” of ISFTA in favour of India⁵.

With regard to exports, Sri Lanka appears to have been able to derive significant benefits from ISFTA during 2002-2005, attributable to Vanaspathi⁶ and Copper exports to India, as indicated by the “export peak” (refer to Figure 2) in the ISFTA-favoured category.

Figure 2: Evolution of Sri Lankan Exports to India against Sri Lanka’s GDP



However, as evident from the Figure 2, this “surge” has completely disappeared by 2008 when Indian authorities took counter-measures⁷, and therefore, the exceptional export peak, which could not be sustained, was excluded when comparative medium term trends of exports to GDP ratios (Table 3) were computed.

⁵ This could be contested as “trade diversion”, according to trade theories, is when trade shifts take place owing to preferential tariff systems yielding overall welfare losses.

⁶ A product, manufactured of partially hydrogenated vegetable oils, used in cooking and in manufacturing of confectionaries.

⁷ The tariff advantage

External Challenges to Shipping Unit Status of Sri Lanka

Table 3 : Sri Lanka's Exports as a ratio of GDP 1994 -2010

| Origin \ d(X)/d(GDP) | ISFTA-Negative category | | ISFTA-favoured category | |
|-------------------------------------|--------------------------|---------------------------|--------------------------|---------------------------|
| | Pre-ISFTA (1994-1999) | Post-ISFTA (2000-2010) | Pre-ISFTA (1994-1999) | Post-ISFTA (2000-2010) |
| Exports to India | - 0.06 | 0.26 | 0.21 | 0.63 |
| Exports to the rest of the world | 15.00 | - 1.04 | -0.33 | 2.25 |

Source : Authors' Estimations

In relation to GDP, the performance of Sri Lanka's exports to non-Indian markets has been better in the ISFTA favoured category, while the inverse has happened in the ISFTA negative category. This would not be expected if the ISFTA was "effective".

With regard to Sri Lanka's exports to India, the ratio to GDP has grown much faster in the ISFTA-negative category than in the category where Sri Lankan exports would enjoy preferential treatment under the ISFTA⁸. Thus, it could be concluded that the ISFTA has not been "effective" in promoting Sri Lankan exports to Indian market.

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⁸ With the exception of the cases of Vanaspathi and Copper exports.