CHAPTER 3

Impact of Trade Imbalances: Contemporary Trade Policies and Agreements

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Abstract

Large trade imbalances tend to exert pressure on both the exchange rate and the interest rate in the process of seeking for some balancing in the external trading sector. However, this market forces led reaction gets diluted if there are large capital inflows to the capital account of the balance of payments. Most inflows to the capital account in Sri Lanka during 2009-2011 were of a borrowed/temporary nature. Exchange rate/interest rate management should not be driven by headline foreign reserves alone, rather, the non-borrowed reserve position should also be seriously considered and this was not the case in Sri Lanka during the period mentioned. Sri Lanka has maintained an appreciated exchange rate over the last half decade due to reasons best found in the political economy. Due to the appreciated exchange rate, the export share in GDP and the global market has declined over the last 5 years while imports have increased disproportionately, among other factors due to escalation of oil prices in the world market. The adverse impact of appreciated exchange rates on the import substitution industrial sector has been compensated by increased tariff protection, sometimes exceeding the WTO binding commitments. This may be a consequence of mainstreaming trade policy with the overall development strategy, but we have to be cautious in this respect and be within the binding limits.
Exports have shown high growth in recent months. However, these high growth rates have to be read with caution due to: (a) depreciating US Dollar in the global market, and (b) competitor countries showing a higher export growth than Sri Lanka (Kelegama, 2011a). Moreover, unhealthy signs were emerging on the overall exports of Sri Lanka as shown in Figure 1 and Table 1, where Sri Lankan exports as a share of global exports have been declining since the year 2000. As a share of GDP also, exports have been declining from 26 per cent in 2000 to 17 per cent in 2010 (Table 2).

Table 1: Share of Exports in Global Exports

<table>
<thead>
<tr>
<th>Year</th>
<th>Export Share (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>0.06</td>
</tr>
<tr>
<td>1995</td>
<td>0.08</td>
</tr>
<tr>
<td>2000</td>
<td>0.09</td>
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<tr>
<td>2005</td>
<td>0.06</td>
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<tr>
<td>2006</td>
<td>0.06</td>
</tr>
<tr>
<td>2007</td>
<td>0.06</td>
</tr>
<tr>
<td>2008</td>
<td>0.05</td>
</tr>
</tbody>
</table>

Source: IMF (various issues).

Table 2: Export Share in GDP

<table>
<thead>
<tr>
<th>Year</th>
<th>Export Share (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>25</td>
</tr>
<tr>
<td>1995</td>
<td>29</td>
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<tr>
<td>2000</td>
<td>33</td>
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<td>23</td>
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<tr>
<td>2008</td>
<td>21</td>
</tr>
<tr>
<td>2009</td>
<td>17</td>
</tr>
<tr>
<td>2010</td>
<td>16</td>
</tr>
</tbody>
</table>

Source: CBSL (various issues).

The decline in export share over the years and rapid increase in imports raises a fundamental question on the exchange rate. An examination of the behaviour of the real effective exchange rate over the last decade shows a clear appreciation. According to the Central Bank of Sri Lanka, during 2010 both Nominal Effective Exchange Rate (NEER) and Real Effective Exchange Rate (REER) appreciated against all the major currencies except Japanese Yen and Indian Rupee. While the Central Bank of Sri Lanka admitted this reality, during 2006-2011, the exchange rate was defended at the levels between Rs. 108 and Rs. 111 per US dollar on the grounds of maintaining an overall conducive policy environment in terms of maintaining inflation at a low level, facilitating debt repayment, and encouraging investment by foreigners in both treasury bills and bonds, etc.² Political factors such as maintaining a

² These views were reflected in interviews given to newspapers by the Governor of the Central Bank of Sri Lanka.


Web links from 01 December 2011 and 31 January 2012, The Island newspapers. Views pontificated on the exchange rate were reversed completely on 03 February 2012.
stronger currency for enhancing national pride and false notion such as an appreciated rupee can facilitate achieving the declared goal of the government of doubling the per capita income by 2016, also seems to have influenced this policy. That there was a determination to target the exchange rate at a particular level/band is seen by the Central Bank selling Dollars in the market whenever there was pressure for the rupee to depreciate. LBO estimates that close to US$ 1 bn. was utilized from the foreign exchange reserves to defend the Rupee during a 10 week period from July to September 2011. A similar currency defending was resorted to in late 2008 before the IMF package which led to a serious depleting of foreign exchange reserves (see Kelegama, 2009).

As foreign reserves amounting to around US$ 8 bn. (in October 2011) which was equivalent to more than 6 months imports were built up after the IMF package in April 2009, there was an unfounded confidence that they should be freely used to defend the currency.

A closer look at the reserves however, reveals that such a currency defending with reserves was unsustainable. Figure 2 shows the disaggregated behaviour of foreign reserves for December 2007 to August 2011 period. It has been clear after the IMF package, that the growth of reserves has been determined mainly by borrowed funds: foreign inflows to Treasury Bills and Treasury Bonds, Sovereign borrowing by the Government of Sri Lanka for development work, and IMF instalment funds. The non-borrowed reserves on the other hand, have been on the decline since about October 2009 despite increase in the inflow of remittances.

During the 2009 foreign exchange crises, the options of currency depreciation or going to the IMF were totally ruled out by the Central Bank of Sri Lanka. But by learning the hard way, the IMF was approached in February/March 2009 for rescue and thereby, a drastic depreciation of currency was avoided. While foreign reserves remained adequate for two years since the commencement of the IMF programme in July 2009, the growing trade deficit was seen by market players as a sign of worry. The market players were smart and they knew that the currency defending strategy using existing reserves was unsustainable despite various assurances given by the authorities, even late as January 2012. Thus, they realized that maintaining the status quo of not adjusting exchange rates or interest rates will only make the strains on the economy worse in the coming months.

3 www.lbo.lk

4 'No Devaluation, No IMF Bail Out' was the headline inserted by the Central Bank in the Ceylon: http://www.dailynews.lk/2009/01/19/news01.asp Daily News of 19 January 2009.

5 See The Island of 31 January 2012 where assurance was given in regard to the exchange rate stability by the Central Bank. http://www.island.lk/index.php?page_cat=article-details&article_id=44257
A frequent argument put forward when defending the appreciated exchange rate policy was that when there were large capital inflows there was pressure on the exchange rate to appreciate further and this was avoided by the Central Bank of Sri Lanka by buying Dollars in the market. This was done, it was said, to support the export sector. No doubt this policy was a positive step but when there were large capital outflows and there was pressure for the currency to depreciate, such depreciations were prevented by Dollar sales in the market. It was this downward rigidity of exchange rate policy that came into criticism by the IMF in recent months (www.imf.org/srilanka). In other words, exchange rate flexibility downward was artificially restricted thus creating an adverse impact on export growth.

If the government was reluctant to undertake a first best policy of allowing depreciation of currency, at least it could have used a higher interest policy rate to discourage borrowing for imports or impose higher traffic on non-essential imports or use a combination of these policies. None of these policies were attempted on the argument that they would stifle growth and that there were large foreign inflows in the pipeline. The growing current account deficit was essentially seen as a 'cash flow' problem like in the corporate sector financial accounts. In other words, there was a belief that the status-quo was sustainable.

Since July 2011 till early February 2012, close to US $ 2.5 bn was utilized from the foreign exchange reserves to defend the currency. This not only reduced the reserves to US $ 5.5 bn but also drained rupee liquidity from the banking sector and close to Rs. 300 bn was printed to infuse rupee liquidity into the banking system to keep the interest rate at bay.

What the pre-February 2012 exchange rate regime did was to make imports cheaper, thereby contributing to further imports flows. Vehicle imports, for instance, almost doubled between 2010 and 2011 from US$ 546 mn. to US$ 1001 mn. On the other hand, cheap consumer durable imports exerted pressure on many import substitution industries, such as cosmetics, leather shoes, etc., and these industrialists successfully lobbied with the government for additional protection and opposed deepening existing FTAs. This protection came in the form of a CESS (Commodity Export Subsidy Scheme), Surcharge, Special Levy, halting deepening of FTAs, etc., and complicated the overall tariff structure. Domestic cosmetic companies, for instance, succeeded in obtaining a Rs. 350 CESS (increased from the earlier rate of Rs. 200) in the November 2010 Budget, and got it further increased to Rs. 500 in the November 2011 Budget. The Trade Policy Review of the WTO highlighted that the average MFN tariff rate in Sri Lanka has increased from 9.8 per cent in 2003 to 11.5 per cent in 2010, thus negating the multilateral commitments for liberalization. Moreover, due to some of these new add-on taxes, Sri Lanka had violated binding commitments with the WTO where the applied rate overshot the binding rate. WTO (2010) identified 143 items in the manufacturing sector of such overshooting. Pursell (2011) shows that there has been significant trade liberalization reversals in both Sri Lanka and Bangladesh and that Sri Lanka’s tariff structure has become opaque since the policy reversals started in 2005.

The Presidential Taxation Commission (PTC) had a close scrutiny of the external tariff and found that while import duties amounted to 2 per cent of GDP, the overall customs revenue amounted to 8 per cent of GDP due to add-on taxes in the border such as CESS, Surcharge, etc. Most of these add-on taxes served a protectionist role, although they contributed more to tax revenue (PTC, 2010).

The other key area in regard to trade policy is liberalization of trade in services. The government policy clearly articulates the creating of five hubs in Sri Lanka, viz., shipping, aviation, knowledge, commercial, and financial (GOSL, 2010). The creation of hubs requires a liberal trade

6 http://www.thesundayleader.lk/2011/02/20/silenta-protests-new-rs-350-import-cess/
policy and in this regard much needs to be done. Already some steps have been taken to further liberalize financial transactions by permitting the private sector to borrow overseas, liberalizing the tertiary education sector by allowing the domestic private sector and foreigners to invest in the sector, and so on, but these measures are inadequate to fully support the proposed hubs.

Perhaps, under the current recessionary global conditions the desire to liberalize has slowed down. But a gradual attempt has to be made unilaterally to liberalize in the area of services relevant to the identified hubs. Recently, Sri Lanka exchanged its ‘offer’ and ‘request’ list with other SAARC countries under SAFAS (South Asia Framework Agreement on Services). The full implementation of limited liberalization under this framework might commence in 2012. Bilateral attempts to liberalize services under the proposed India-Sri Lanka CEPA (Comprehensive Economic Partnership Agreement) have come to a standstill due to protest from the protectionist segments of the domestic private sector. CEPA would have provided a testing ground for services trade in Sri Lanka but the opportunity has been postponed over political imperatives.

3. The Policy of Regional Trade Agreement

Sri Lanka is currently a member of two regional preferential trade arrangements, viz., SAFTA (South Asia Free Trade Agreement) and APTA (Asia-Pacific Trade Agreement) and two bilateral free trade agreements, viz., ISLBFTA (India-Sri Lanka Bilateral Free Trade Agreement) and PSLBFTA (Pakistan-Sri Lanka Bilateral Free Trade Agreement). Currently, under the four arrangements there is underutilization of preferential market access due to a number of reasons, such as: lack of supply capacity, para-tariff in the destination country nullifying the preferential margins, problems of complying with rules of origin, etc. These areas need to be studied carefully and appropriate remedial measures should be implemented to make best use of the FTA arrangements. RTAs are not without their own problems and the answer to it is not shying away from the problems and signing new FTAs with other trading partners, but consolidating the existing RTAs.

The consolidation process involves several steps depending on the type of RTA. In the case of SAFTA, Sri Lanka will benefit by its deepening and broadening, the former will result with the reduction of the current ‘negative list’ from 20 per cent tariff lines to a lower level, and the latter will occur with SAFAs where liberalization of goods is complemented with liberalization of services. As a first step, India reduced its ‘negative list’ to 25 items to all SAARC countries on a non-reciprocal basis at the 17th SAARC Summit in Male in November 2011.

APTA is based on a ‘positive list’ tariff preferences and its coverage of goods will be less than a ‘negative list’ based RTA. APTA has taken steps to deepen tariff margins and incorporate trade in services and investment flows into the agreement but is waiting for final ratification by India. Once these features are incorporated into APTA, it will become a more effective RTA. Sri Lanka receives preferences to the Chinese, South Korean, and Lao markets via APTA and there is a need to better utilize these openings, especially by exporters to the Chinese Market.

The more advanced stages of FTAs are CEPAs. Realizing that the FTA between India and Sri Lanka needs to be deepened and broadened to reap the maximum benefits of the ISLBFTA, Sri Lanka and India embarked on CEPA talks in 2002. Following the exchange of the Joint Study Group report in October 2003 between the two leaders of India and Sri Lanka, CEPA dialogue/negotiations commenced in early 2005 and were completed in mid-2008. The Agreement was ready for signing by the two Heads of State at the time of the 15th SAARC Summit in Colombo, but was postponed due to protest by a group of businessmen led by

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8 This policy initiative is currently on hold due to protests from some stakeholders.
businessmen who encountered a bitter experience in doing business in India\(^9\). The Government of Sri Lanka accommodated the protest and postponed going ahead with the CEPA agreement with India.

The important question to pose here is, can Sri Lanka promote the five hubs bypassing India? Is Sri Lanka to drag CEPA for a longtime until it faced a natural death or going ahead with the Agreement, modified to face the contemporary changes? If so when? These questions are important especially at a time when the Western Markets are in recession and the need for Sri Lanka to find new markets in the South, particularly in the region, and India features prominently in this context.

That CEPA is the next stage of FTAs is now universally accepted. For instance, the WTO website indicates that there are 84 such agreements in operation either known as a CEPA or CECA (Comprehensive Economic Cooperation Agreement) or EPA (Economic Partnership Agreement).

The path towards a CEPA can be obstructed or diluted not only by protectionist lobbies but also by various groups that thrive on economic nationalism/patriotism and those who inflict fear of big-power domination and economic colonization by India. It must be noted that just like in the ISLBFTA, the asymmetry between India and Sri Lanka has been taken into account in the ISL-CEPA framework. ISLBFTA designed Special and Differential treatment in favour of Sri Lanka by granting a longer trade liberalization period, large negative list, favourable Rules of Origin for Sri Lanka, etc., (Kelegama, and Mukherji, 2007). Likewise, Sri Lanka has been offered more market access for services compared to Indian market access to Sri Lanka and the Economic Cooperation component of the CEPA has been totally in favour of Sri Lanka as per the framework.

International literature shows that for trade agreements to succeed, they require political leadership. If the fate of CEPA is left entirely in the hands of the Sri Lankan private sector, it is unlikely that it will become a reality as there will be different views from one extreme to another on deeper economic integration with India. Once technocrats complete the framework agreement, the political establishment has to carry it forward for completion.

CEPA provides a rule-based framework for trade and investment between Sri Lanka and India. Such a framework provides more certainty to trade and investment regimes of both countries and to each other’s traders and investors. This is all the more important to attract good quality investment and trade and discourage fly-by-night investors/traders. Given the significant growth of the Indian economy and its proximity to Sri Lanka, India provides an excellent market for trading, investment, and promoting the proposed five hubs in Sri Lanka.

It is said that investment follows trade and that the trade-investment nexus could be strengthened by investment flows between countries. One way of strengthening the trade-investment nexus between India and Sri Lanka is via CEPA. With a liberal and rule-based investment regime, efficiency-seeking Indian industrial restructuring can source Sri Lankan industries, form joint ventures, engage in subcontracting, become part of the value-chain, etc. This in turn, will promote more intra-industry trade (IIT) based on economies of scale and industrial agglomeration. Vertical integration among industries in South Asia is at a low level (De Mel and Jayaratne, 2012) and this in turn, is one reason for the low level of intra-regional trade. Under CEPA, such integration between the two countries could be strengthened and increase Sri Lanka’s exports to the Indian market.

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\(^9\) A Sri Lankan Biscuit manufacturer who failed to do the due diligence before purchasing a debt ridden Indian biscuit company underwent large legal expenses to settle the purchase related problems. A cosmetic manufacturer who tried to sell his products in the Indian market was pushed from pillar to post and encountered a bitter experience in the Indian market. These entrepreneurs in particular ensured that a CEPA would be not signed.
4. Concluding Remarks

Sri Lanka needs to address the growing trade imbalances by enhancing exports and restricting imports under the market economy framework. The exchange rate, interest rates, and tariff policy will play a crucial role in this exercise but the best policy option would be an exchange rate adjustment despite its other political economy implications. While taking steps towards addressing the trade imbalance, Sri Lanka needs to enhance its exports by making full use of the existing regional and bilateral free/preferential trading agreements.

It was argued that it will be sensible to strengthen and consolidate the existing FTAs rather than embarking on new FTAs. With global recession reducing the demand for exports from Sri Lanka in the US and EU markets, Sri Lanka should make a concerted effort to gain market access in growing Southern markets in China, India, ASEAN, Gulf, etc. For entry into the Chinese market, the APTA may be useful, and for India, the ISLBFTA and the proposed ISL-CEPA will be useful. It is thus important to make best use of these existing agreements by deepening and broadening them. Trading and investment relations with India are key for promoting the five hubs articulated in the government policy framework. In this context, liberalization of trade in services will have to be considered in a gradual manner and the proposed ISL-CEPA provides a framework to kick-start the process.

Sri Lanka’s trade policy framework has four components: (a) Unilateral Liberalization, (b) Multilateral Liberalization, (c) Regional Liberalization, and (d) Bilateral Liberalization (Kelegama, 2006). With the deadlock in the Doha Development Round, the multilateral liberalization has come to a standstill or a slow process. The regional liberalization is taking place under SAFTA—there again, at a slow pace. Bilateral liberalization with India and Pakistan has taken place faster but reduction of the ‘negative lists’ is yet in the agenda. Unilateral liberalization in the goods sector has almost halted but in services there is some progress. These four components of trade policy will have to be carefully used in the context of mainstreaming trade policy to the overall development policy in Sri Lanka in the context of promoting the five hubs, developing SMEs and large-scale infrastructure projects (Kelegama, 2011b).

For such mainstreaming, there is a need for an integrated approach for trade policy making/formulation in order to ensure WTO compliance and fulfillment of bounding commitments in both regional and bilateral free trade agreements. Such an approach will ensure that the development agenda is supported by trade policy while ensuring compliance with international obligations.

References


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