

Study on China-Sri Lanka Free Trade Agreement

Prepared

By

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For

The Ceylon Chamber of Commerce

The National Chamber of Commerce of Sri Lanka

The National Chamber of Exporters

The Ceylon National Chamber of Industries

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Executive Summary

Sri Lanka has shown interests in exploring a bilateral trade agreement with China. Both countries now have agreed that they would embark on a free trade agreement, which is hoped to open up the vast Chinese market to Sri Lanka's producers, manufacturers and exporters. This would not only boost bilateral trade but help reduce Sri Lanka's heavy reliance on traditional markets in Europe and USA. In this regard, it is imperative that the agreement covers a substantial number of tariff lines and trade as well as address non-tariff barriers that may hinder export expansion. Considering the reservations about adverse effects of a FTA with China, the agreement needs to be prepared carefully taking into account asymmetries between the two economies, with a rational negative list and a longer phase-out liberalisation schedule. In this context, it is necessary to draw on Sri Lanka's experience from existing FTAs to identify key challenges relating to both tariff and non-tariff barriers to trade; highlight the key features of China's existing FTAs with countries/regions to get a sense of what a possible FTA with China would look like; and identify Sri Lanka's existing and potential export products to China, which should form part of negotiated trade agreement with China.

Sri Lanka's Existing Trade Agreements and Lessons for the FTA with China

Sri Lanka participates in two regional agreements, the South Asian Free Trade Agreement (SAFTA) and the Asia-Pacific Trade Agreement (APTA), and two bilateral agreements, the Indo-Sri Lanka Free Trade Agreement (ISFTA), and the Pakistan-Sri Lanka Free Trade Agreement (PSFTA). Some of the key lessons from Sri Lanka's experience with these existing FTAs must be borne in mind when negotiating a trade agreement with China.

- **Special and Differential Treatment:** Given the asymmetry of economic size, Sri Lanka received special and differential treatment under each of the existing Free Trade Agreements. For instance, Sri Lanka as a small economy was allowed a longer tariff phase-out period, a longer negative list, immediate duty free access for products at the start of the agreement, and more favourable rules of origin under SAFTA, ISFTA and PSFTA.
- **Rules of Origin:** Rules of origin criteria, which are used to determine country of origin under a FTA, have varied among the FTAs in South Asia. SAFTA and ISFTA require a change of tariff classification at the 4-digit level, which has been difficult to meet given the substantial transformation required. Having the experience with ISFTA, PSFTA negotiations adopted less restrictive rules of origin criteria (a change of tariff heading at the HS 6-digit level). In negotiating a trade agreement, it is therefore important to relax and simplify the rules of origin so that they are easy for traders to understand and to comply with, while ensuring the necessary controls are in place to prevent fraud.
- **Negative List:** This list contains sensitive products which are exempted from tariff concessions under the agreement. The negative list should be prepared in consultation with local stakeholders by weighing revenue considerations as well as implications for local industries and livelihoods which may be adversely affected by trade liberalisation. However, it is important to keep the negative lists to a minimum to ensure that a substantial proportion of tariff lines and products are covered under the agreement.
- **Non-tariff Measures:** When tariffs are brought down through negotiations, non-tariff measures (NTMs) can reduce the use of the agreements if they are not effectively dealt with. NTMs should be identified at the onset and addressed along with tariff reductions/eliminations. In this regard, there should be binding commitments.

- **Tariff-rate Quotas:** Although tariff schedules have been liberalized to a certain extent under ILFTA and PSFTA, Sri Lanka's trade expansion with India and Pakistan has been impeded by tariff-rate quotas agreed under the Agreements.
- **Mutual Recognition of Standards:** Lack of a Mutual Recognition Agreement (MRA) for standards between Sri Lanka and its FTA partners has resulted in various additional checks/certifications on the goods at the point of import, even though they have been previously tested and certified by the relevant authorities in Sri Lanka.
- **Awareness:** Lack of knowledge and awareness among traders of the concessions offered by the FTAs has been a key impediment to garnering maximum benefits of existing FTAs.
- **Visas:** Traders have highlighted the need to facilitate the visa processes between two countries if trade relationships between them are to be enhanced.
- **Institutional Support:** The absence of a fixed body to address problems arising when trading under the agreement is an impediment to using the FTAs. When problems arise regarding a shipment there needs to be a formal body of authority to take up complaints and address them quickly.
- **Consultation:** Experience with the ISFTA, and attempts to extend the agreement into a Comprehensive Economic Partnership Agreement (CEPA), highlights the need for greater private-public dialogue in Sri Lanka on trade agreements, on an on-going and regular basis.

China's Approach to FTAs with Other Countries

China has been actively pursuing FTAs with various countries over the past two decades. China has concluded FTAs, or entered into negotiations, with almost every major region in the world. By June 2014, China had become a party to 11 bilateral trade agreements and one regional trade agreement - ASEAN , Hong Kong , Macao , Chile , Pakistan , New Zealand , Singapore , Peru , Costa Rica , Taiwan , Switzerland and Iceland .

- **Gradual Approach to Trade Liberalization:** China has adopted a gradual approach in negotiating with trading partners – first, striking an agreement in trade in goods, then services and investment, followed by a comprehensive FTA package. China's FTAs with ASEAN, Chile, and Pakistan followed such an approach. In contrast, agreements with New Zealand, Singapore, and Peru were more comprehensive in scope at the time of signing.
- **Coverage of tariffs and goods:** For most of China's FTAs partners, the agreements have eliminated tariffs and allowed preferential market access to China, to a great extent. For example, in its agreements with Chile, Peru and New Zealand, China committed to eliminate duties on 94.6% to 97.2% of the tariff lines, which corresponded to 88 - 99.1% of its bilateral imports from these trading partners. The only exception to this is the China-Pakistan FTA.
- **China's Negative Lists:** China's FTAs take into account the sensitiveness of both countries and contain Negative Lists, which exclude a number of products from tariff liberalisation. A number of vegetable products, animal and vegetable fats and oils, prepared food, chemicals, wood products, pulp and paper, and textile categories are protected by China. In almost all of the agreements, China has placed pulp and paper in its negative list. Nevertheless, almost all of the agreements cover a substantial number of tariff lines and trade.
- **Rules of Origin:** They tend to vary from agreement to agreement. Sometimes they are across product groups, which add to the complexity of China's import regime. Rules of origin criteria for China's FTAs with ASEAN, Chile, Pakistan, and Singapore are Local Value Addition (40% of total content) and Regional Value Content (60% of the value of the product). The criteria for Peru, New Zealand and Costa-Rica are Change of Tariff Classification (HS 2-4 digit level) and Regional Value Content (40-60% of the value of the product).

- **Services Liberalisation:** While the Agreements on Trade in Goods have taken a Negative List approach, China's Trade in Services Agreements have taken a Positive List approach. In China's FTAs with ASEAN, Chile, and Pakistan, the Agreement on Services is a separate document and follows the Agreement on Goods, while in the case of other partner countries (New Zealand, Peru, Singapore, Costa Rica), the FTA agreement were more comprehensive in coverage and included not only trade in goods but also services.
- **Cooperation Beyond Tariffs:** Due to their focus on liberalizing markets and facilitating trade, agreements between China and other developing countries aimed at reducing tariffs and non-tariff barriers to trade. Moreover, China was reluctant to include issues such as environment protection, competition policy, and labour standards as part of the FTA package. However, China has shown some willingness to broaden its focus and include these issues over time. Nonetheless, China has taken a cautionary approach and chosen not to include them in the main agreement of the FTA but as stand-alone agreements or MOUs.

Sri Lanka's Potential Exports to China under Proposed FTA

- Sri Lanka has a comparative advantage vis-à-vis the world in 566 products (at HS 6-digit level), out of which China does not import 24 products from the world.
- Of the 542 potential exports to China, Sri Lanka already exports 243 products. The other 299 products with trade potential to China are currently not exported by Sri Lanka to China but are imported by China from rest of the world, presenting new market opportunities for Sri Lankan producers, manufacturers and exporters. Appendix 1 lists the 542 potential exports.

Recommendations

- When negotiating with China, Sri Lanka should be mindful of the issues it has encountered with its existing FTAs. Similar challenges need to be thought out and addressed in an agreement with China to ensure Sri Lanka can fully benefit from a FTA with China.
- Given that China has adopted a flexible and less stringent approach in its FTAs, Sri Lanka should make use of this stance to reflect its trade interests.
- With regard to trade liberalisation programme, it would be best to adopt a gradual approach; Sri Lanka should first sign an agreement on trade in goods before dealing with services, and other complex issues to build confidence amongst stakeholders in the country.
- In seeking a trade deal in goods with China, Sri Lanka should obtain special and differential treatment given the asymmetries between the two countries (i.e., longer phase-out period.)
- While bearing in mind the sensitivities of both countries, China's FTAs have eliminated tariff and allowed preferential access to a great extent. Given that China's negative list appears to be based on principle of reciprocity, Sri Lanka needs to decide on the length of its own list.
- Trade negotiations with China should not only cover products in which Sri Lanka currently exports but also has a potential exports to China.
- Tariff concessions awarded by China should be higher or at least equivalent to the tariff reductions granted to other countries by China under its various free trade agreements.
- China's rules of origin vary by agreement and products. Sri Lanka should negotiate in line with its existing preferential Rules of Origin and adopt rules which are simple and achievable.
- Closer consultation between the government, and other stakeholders in the economy including the private sector, and civil society of the country. This can ease exporter-importer concerns, and help create broader public awareness of, and confidence in, the opportunities and benefits of the agreement.