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POLICYINSIGHTS

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CHINA-SRI LANKA FREE TRADE AGREEMENT: PRIORITIES FOR NEGOTIATIONS

China and Sri Lanka have commenced negotiations on a Free Trade Agreement (FTA), which hopes to open up the vast Chinese market to Sri Lankan products. The Agreement is expected not only to boost bilateral trade but also help reduce Sri Lanka's dependence on traditional markets in Europe and USA. With the commencement of initial round of negotiations, it is necessary to consider how best the Agreement could be drawn to ensure Sri Lanka maximises benefits whilst minimises associated costs from a FTA.

This Policy Insights highlight the main findings from the IPS study on 'China-Sri Lanka Free Trade Agreement'. The objectives of the study were: 1) to draw lessons from Sri Lanka's existing FTAs to identify key stumbling blocks to trade liberalisation; 2) to describe key features of China's FTAs; and 3) to identify products with export potential to China, which should be included in the negotiations with China.

Lessons from Sri Lanka's Existing Trade Agreements

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). There are a number of lessons from the existing agreements that must be borne in mind when negotiating a trade deal with China.

- **Special and Differential Treatment (S&D):** Given the asymmetry of economic size, Sri Lanka received S&D treatment under each of the existing trade deals. 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, and more favourable rules of origin under SAFTA, ISFTA and PSFTA.

- **Rules of Origin (ROO):** These criteria, which are used to determine the country of origin under a FTA, have varied between agreements. SAFTA and ISFTA require a change of tariff classification (CTH) at 4-digit level, which has been difficult to meet given the substantial transformation required for a product. PSFTA adopted less restrictive criteria (CTH at HS 6-digit level).
- **Negative Lists (NLs):** This list contains sensitive products which are exempted from tariff liberalisation. NLs should be prepared by weighing revenue considerations as well as implications for local industries and livelihoods. However, it is important to keep the NLs to a minimum to ensure that a substantial proportion of tariff lines and products are covered under the agreement.
- **Non-tariff Measures (NTMs):** When tariffs are brought down through negotiations, NTMs can reduce the use of agreements. NTMs should be identified at the onset and binding commitments made for their reductions/eliminations.
- **Tariff-rate Quotas:** Although tariff schedules have been liberalized to a certain extent under ISFTA and PSFTA, Sri Lanka's trade expansion with India and Pakistan has been impeded by imposition of tariff-rate quotas.
- **Mutual Recognition of Agreements (MRAs):** Lack of MRAs for standards between Sri Lanka and its FTA partners have resulted in various additional checks/certifications on the goods at the point of imports, impeding the free movement of goods.
- **Awareness:** Lack of knowledge and awareness among traders of the concessions have been a key obstacle

to garnering maximum benefits of existing FTAs.

- **Institutional Support:** The absence of an established body, to address problems arising when trading under the agreement, is an impediment to the use of 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.

China's Approach to FTAs



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 was 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:** China has adopted a gradual approach in negotiating with trading partners - first, striking an agreement in trade in goods, then services and investment agreements. However, recent agreements 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 95% to 97% of the tariff lines, which corresponded to 88 - 99% of its bilateral imports. The only exception to this is the China-Pakistan FTA.

- **China's Negative Lists (NLs):** China's FTAs take into account the sensitivity of both countries and contain NLs. 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 NLs.
- **Rules of Origin (ROO):** They tend to vary across agreements and product groups, which add to the complexity of China's import regime. ROO criteria of 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 agreements with 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 Services Agreements have adopted 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 others, the Agreements were more comprehensive in coverage and included both trade in goods and services.
- **Cooperation beyond Tariffs:** Due to their focus on liberalizing markets and facilitating trade, agreements between China and developing countries aimed at reducing tariffs and NTMs to trade. However, China has shown some willingness to broaden its focus and include other issues (environment protection, competition policy, and labour standards) over time. Nonetheless, China has been cautious, choosing to include them as stand-alone agreements or MOUs.

Sri Lanka's Existing and Potential Exports to China under Proposed FTA



Trade between Sri Lanka and China has grown steadily over the years, with total trade almost tripling between 2009 and 2013. While Sri Lanka's exports to China have steadily grown over the years, imports

from China have grown at a faster rate. Consequently, Sri Lanka has been experiencing an expanding trade deficit with China. In 2013, Sri Lanka had a trade deficit of USD 2.8bn.

As an export market, China is not an important destination. It ranks at 16th place and accounts for about 1.2% of Sri Lanka's total exports. However, China's importance as an export destination seems to be on the rise given that exports to China have been growing at a faster rate than Sri Lanka's exports to the rest of the world during the last 5 years.

In 2013, Sri Lanka exported USD 122mn of goods to China, of which textiles and clothing accounted for almost 40% of exports, followed by vegetables, plastics and rubber, food products and minerals. These four categories accounted for over 80% of Sri Lanka's exports to China. While some products already receive preferential rates under APTA, China has extended duty free access for these products to other competing countries (i.e., ASEAN). For example, ASEAN already enjoys zero duties for almost all of Sri Lanka's top ten exports in China. Therefore, in negotiating an agreement with China, Sri Lanka should seek immediate duty access for these products.

Sri Lanka has a comparative advantage vis-a-vis the world in 566 products (at HS 6-digit level), out of which Sri Lanka currently exports 243 items to China (Figure 1). There are additional 299 products with trade potential to China, which are not exported by Sri Lanka to China but are imported by China from the rest of the world, presenting new market opportunities for Sri Lankan exporters. In fact, Sri Lanka has the potential to increase exports to China across all product categories, especially textiles, vegetable products, plastics/rubber (Table 1).

Figure 1: Products with Comparative Advantage vis-a-vis World and China (CH), HS 6 Level

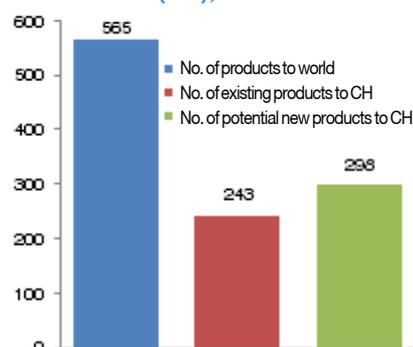


Table 1: Existing & Potential Number of Exports to China, Sector-wise

Animal & Animal Products	24
Vegetable Products	63
Foodstuffs	28
Mineral Products	9
Chemicals & Allied Industries	17
Plastics / Rubbers	30
Raw Hides, Skins, Leather, & Furs	6
Wood & Wood Products	28
Textiles	240
Footwear / Headgear	14
Stone / Glass	18
Metals	18
Machinery / Electrical	21
Transportation	7
Miscellaneous	18

Recommendations

- Trade negotiations with China should not only cover products in which Sri Lanka currently exports but also has a potential to export to China. 
- Negotiations should seek concessions which are higher/at least equivalent to tariff reductions granted to competing countries under China's FTAs.
- Rather than agreeing on general ROO, the negotiations should focus on achievable product-specific ROO, as the requirements across products.
- Though China's existing FTAs are based on the principle of reciprocity, Sri Lanka should seek S&D treatment given the asymmetrical economic relation.
- Potential benefits of allowing preferential market access to Sri Lanka must be carefully assessed taking into account domestic interests and sensitivities. This would require closer consultations with stakeholders including the private sector.
- There should be binding commitments not to resort to the use of NTMs as a means of circumventing tariff reductions.
- To achieve a more comprehensive bilateral cooperation between the two countries, the FTA should gradually move beyond trade in goods to cooperation in other areas such as investment, services and trade facilitation to build confidence in a negotiated trade agreement.

This brief is based on findings from a study on 'China-Sri Lanka Free Trade Agreement' carried out by Janaka Wijayasiri, Dharshani Premaratne, Suwendrani Jayaratne and Nipuni Perera. Contact janaka@ips.lk or dharshani@ips.lk for more information.



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