

Conference on  
Ten Years of the India-Sri Lanka Free  
Trade Agreement: Achievements,  
Challenges & the Road Ahead

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Plan of Presentation

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## Background

- Long before bilateralism in trade relations became the most prevalent tool of commerce among developed and developing countries and between them since the beginning of the new millennium, India had a long track record of such relationship with two its least developed neighbors, namely Nepal and Bhutan. The Indo-Lanka Free Trade Agreement (ILFTA) was the first such Agreement India signed with a non-least developing neighboring island economy in December 1998. The Agreement came into operation in March 2000.
- The Agreement provides for duty free as well as duty preference access for the goods manufactured in the two countries. With the coming into operation of the Agreement, both the countries have listed products for immediate duty free entry into each other's territories. India has phased out its tariffs on a large number of items within a period of three years (2003). Sri Lanka has done likewise in eight years (2008). Both the countries have drawn up Negative Lists in respect of which no duty concessions will apply. These Lists include items on which protection to local industry has been considered essential. Both the countries intend to reduce the items in the Negative List through periodic consultations. Barring the Negative Lists, the two countries now have 'free trade' between them. In March 2010 the first decade of the operation of ILFTA was completed. This paper seeks to take stock of its performance over the decade and to reflect on its strengths and weaknesses with a view to provide guidelines for the future.

## Rationale : Advocacy Studies

- The possibility of a free trade agreement between India and Sri Lanka was brought out several years prior to the signing of ILFTA. Here reference needs to be made by two in-depth studies carried out under the auspices of United Nations University World Institute for Development Economic Research (UN-WIDER) which sought to bring out the rationale and justification of a bilateral free trade agreement between India and Sri Lanka
- In a Preface to the first Report Lal Jayawardena, Director of the Institute, stated  
"While modalities of regional cooperation have broadly been agreed upon, a meaningful operational programme of cooperation among the nations of the SAARC region is yet to be put in place" WIDER took the initiative, in consultation with the Governments of India and Sri Lanka, to support studies that would bring out clearly defined package of proposals facilitating economic cooperation between India and Sri Lanka. The Research and Information System for Non-Aligned and Other Developing Countries (RIS) was designated to carry out the study.
- To increase the volume of bilateral trade between the two countries, it suggested the initiation of an institutional mechanism to negotiate the reduction of tariff and non tariff barriers on trade on products of mutual interest.
- It suggested that the Government of India could consider setting up a revolving fund on which Indian joint ventures abroad could draw upon for their financing needs.
- The study highlighted possibilities of cooperation in manufacturing, services, and human resource development.

### Rationale : Advocacy Studies (contd.)

- A follow-up 9th Study Group Report by WIDER on the same theme of India – Sri Lanka economic cooperation stated that there was growing recognition that the countries of the region cannot rely exclusively on their traditional markets in OECD countries for fast export growth. The economic and trade environment which in the 1960s and 1970s provided a strong magnet for imports into OECD countries from developing countries (particularly from newly industrializing economies), had deteriorated, whereas competition to supply these markets had increased. Hence for a substantial increase in trade growth, South Asian countries needed to diversify their export markets particularly to East Asia and within South Asia
- The emergence of trading blocks (eg. Single EEC market and proposed North American Free Trade Agreement) centered on the major world economic powers poses another challenge.
- The study suggested a number of principles on the basis of which preferential trading arrangements could be institutionalized between India and Sri Lanka. The following principles were highlighted:

### Rationale : Advocacy Studies (contd.)

- All trade should be included except for a small exclusion list of items, the value of which could be limited to a ceiling of 10-15 per cent of total imports.
- Non-tariff barriers such as prohibitions, quantitative restrictions and licensing should be abolished, with the exception of items on the exclusion list.
- Tariffs should be reduced in uniform manner for all items across-the board, except for items in the exclusion list.
- Tariff reductions should be based on the principle of an equivalence of tariffs, across-the board for all items for all items in India and Sri Lanka ( except for those in the exclusion list). The level in both the countries would be the lower rate prevailing in both the countries. The equivalence in tariffs should be brought about in two to three years. Thereafter a minimum 30 per cent margin of preference should be granted by each country.
- Deeper reduction in tariffs, over and above the rates derived on the basis of the equivalence principle and the preferential margin, should be permitted for selected items such as products of joint ventures, including specific consumer durables.

#### Rationale: Experience of Alternative Regional Trading Arrangements

- The move towards bilateralism has also been induced by the two countries experience in participating in alternative preferential trading arrangements at the multilateral/regional levels. The two regional trading arrangements with both the countries' participation of relevance are
- (i) Asia Pacific Trade Agreement (APTA: earlier known as Bangkok Agreement-Asia's First Multilateral Preferential Trading Arrangement initiated under UN ESCAP in December 1975), and
- (ii) South Asian Preferential Trading Arrangement (SAPTA, implemented since December 1995) and following its deepening, to South Asian Free Trade Agreement (SAFTA, implemented since January 2006).

#### Rationale: Experience of Alternative Regional Trading Arrangements

- Both India and Sri Lanka were initial signatories to APTA<sup>[1]</sup>. The progress achieved in trade liberalization through APTA has been dismal as membership has not expanded beyond six and the scope of the Agreement continues to remain confined to 'goods only'. Only three rounds of negotiations have been held till 2006. At the end of the third round the countries had exchanged concessions on only 4270 products with average margin of preference of 27 per cent for Non-LDCs and 59 per cent for LDCs.
  - Figures for 2003 reveals that Sri Lanka imported US \$ 76 million worth of products conceded preferences under its National List of Concessions (NLCs), being 17 percent of its world imports while India imported US \$ 12 million, less than one per cent of its world imports from Sri Lanka the same year. In view of these trends, APTA does not hold much possibility of expanding bilateral trade between the two countries
- <sup>[1]</sup> The other initial signatories included Republic of Korea, Bangladesh, and Lao PDR. China (PRC), acceded to the Agreement in 2001.

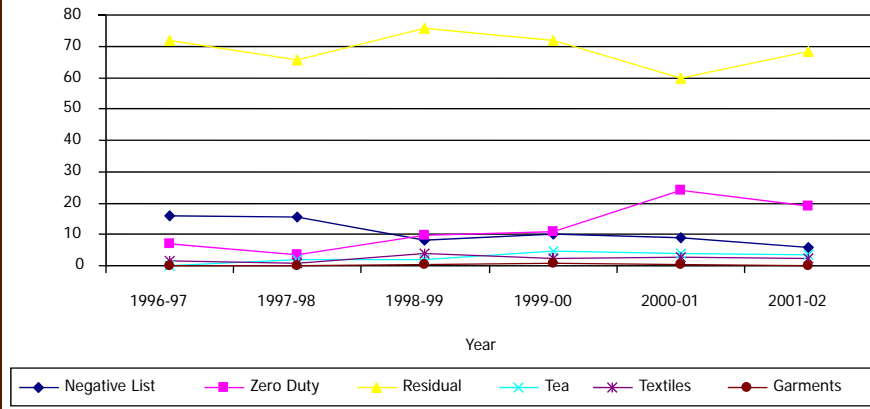
**Rationale: Experience of Alternative Regional Trading Arrangements**

- The experience of the working of SAPTA/SAFTA does not seem to hold much promise for the two countries either. Till the end of third round (August 1999) India had offered concessions on 2927 products of which only 477 were in favor of non-LDCs. While India's margin of preference for LDCs was 50-100 per cent, those for non-LDCs were no more than 20-30 per cent Thus Sri Lanka, being a non-LDC, could not expect much from concessions offered by India.

**India's Import Share in Bilateral Trade of Products Offered Concessions Under different Categories.**

Categories	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02
Bilateral Total Imports(U SD'000)	43985.2	30145.9	37703	44223.9	45010.2	67170.1
<b>Negative List: D(ii)</b>	<b>16</b>	<b>15.66</b>	<b>8.15</b>	<b>10.08</b>	<b>9.03</b>	<b>5.93</b>
Zero Duty: FI	6.98	3.51	9.69	10.78	24.19	19.13
Residual: SLR	71.81	65.72	75.58	71.79	59.79	68.35
Tea	0.12	1.98	1.81	4.56	3.89	3.63
Textiles	1.52	0.81	3.77	2.25	2.71	2.18
Garments	0	0.01	0.51	0.83	0.3	0.1
All Categories	96.43	87.7	99.51	100.29	99.91	99.32

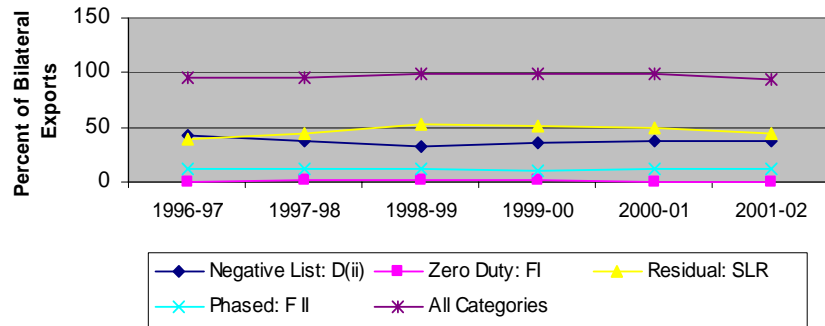
Figure 2: 1: India's Import Share in Bilateral Trade of Products under Different Categories Offered concessions to Sri Lanka: 1996-97 to 2001-02



- India's import share for products under its Negative List has been coming down since 1996-97, being around 6 percent in 2001-02.

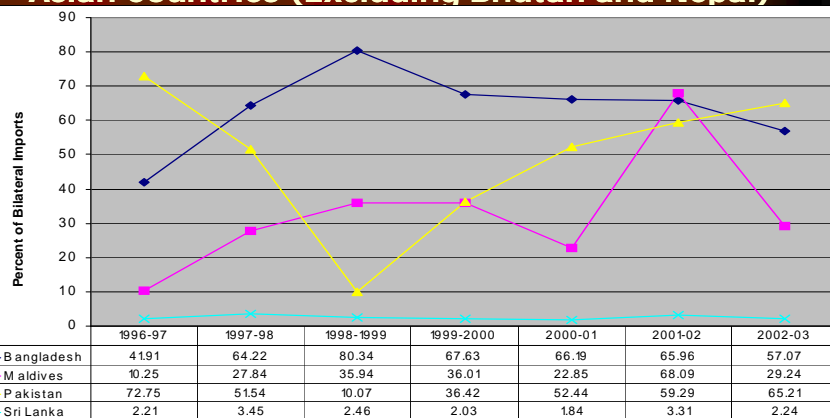
Categories	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02
Bilateral Total Exports (USD '000)	479736.5	488501.9	43444.04	499072.5	640206.2	628939.7
Negative List: D(ii)	43.36	37.3	32.46	36.6	36.66	38.28
Zero Duty: FI	0.84	0.88	1.55	0.97	0.78	0.83
Residual: SLR	39.17	44.07	52.82	51.76	49.19	43.84
Phased: F II	12.66	12.46	12.47	10.23	12.68	11.5
All Categories	96.03	94.71	99.3	99.56	99.31	94.45

India's Exports to Sri Lanka Under Different Categories: Percent share in Bilateral Exports



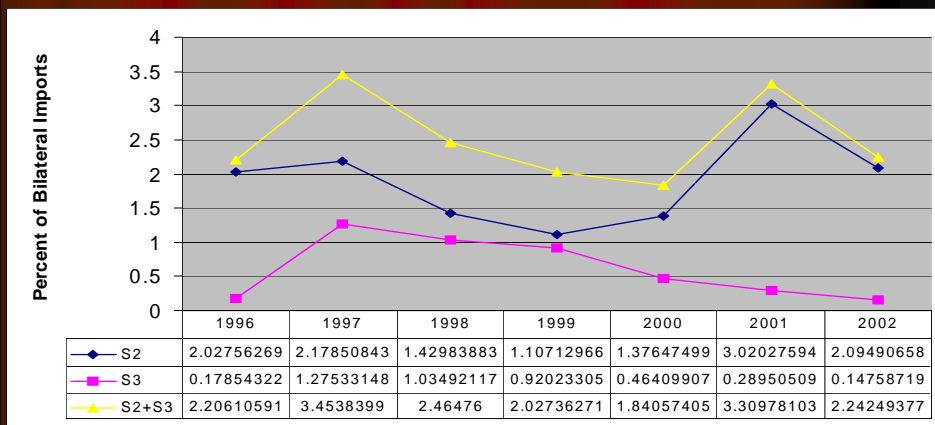
- In 2000-01 around 38 per cent of India's bilateral exports to Sri Lanka was in was in the latter country's Negative List.

Figure 1: India's Preferential Imports from South Asian Countries (Excluding Bhutan and Nepal)



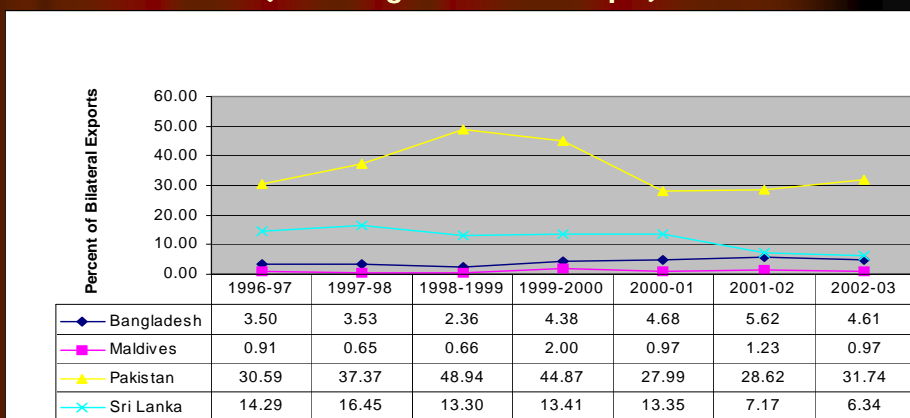
- Figure 1 shows India's preferential imports from South Asian countries as per cent of its total bilateral imports from these countries.<sup>[1]</sup> It will be evident that India has very modest preferential imports from Sri Lanka in a marked contrast with India's similar imports from other South Asian countries. Whereas in 2002-03 India's value of preferential imports in conceded items from Bangladesh, Maldives and Pakistan accounted for as much as 57, 29 and 65 per cent respectively of its total bilateral imports from them, the value share of such imports from Sri Lanka was no more than 2 per cent.  
<sup>[1]</sup> Bhutan and Nepal are excluded as India already has free trade agreements with these countries.

**Figure 2: India's Preferential Imports from Sri Lanka under SAPTA Rounds 1-3.**



- It is also notable that most of the trade preferences were exchanged during the second round. There were no exchanges during first round and very modest exchanges in the third round as will be observed in Figure 2.

**Figure 3: India's Preferential Exports to South Asian Countries (Excluding Bhutan and Nepal)**



- It will be seen that the export value of products on which India received concessions from Sri Lanka declined from 14 per cent of its total bilateral exports in 1996-97 to 6 per cent in 2002-03. This indicates that preferences offered to India by Sri Lanka also failed to stimulate the former country's exports to the latter.



### Rationale: Experience of Alternative Regional Trading Arrangements

- Another issue that emerged during the course of negotiations was that contrary to the spirit of the Agreement, Pakistan continued to offer concessions to India on the basis of its Positive List, which in fact, turned to be negative for the operational requirements and flexibility of the Agreement.
- Under SAFTA a non-LDC Contracting State (CS) may if it so chooses, grant non-reciprocal concessions to an LDC -CS without having to extend the same to another non-LDC- CS. However when a non-LDC grants a concession to another non-LDC, it cannot but extend the same to all CSs including any other non-LDC. This implies that Pakistan must grant concessions to Sri Lanka from the list of products contained in India's Positive List. But such products may not be of interest to Sri Lanka whose comparative advantage could lie in other products. Similarly India could have inhibitions granting concessions to Sri Lanka on products that could as well benefit Pakistan. In the absence of Pakistan not granting MFN status to India, this could be construed as Pakistan free riding on its concessions to Sri Lanka<sup>[1]</sup> To address this problem, it became necessary for Sri Lanka to have two separate free trade agreements first with India, and then with Pakistan<sup>[2]</sup>.
- <sup>[1]</sup> A case in point is tea in respect of which Pakistan would like to extend concessions to Sri Lanka, but not to India.
- <sup>[2]</sup> Pakistan Sri Lanka free Trade Agreement was signed on 1 August 2002 and implemented from 12 June 2005.

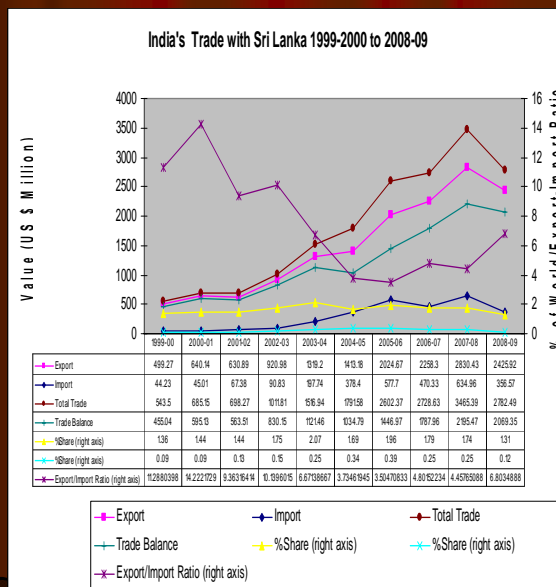
### The Objectives of the Agreement

- Article 1 of the text of the ILFTA spells out the objectives of the Agreement.
- 1. The Contracting Parties shall establish a Free Trade Area in accordance with the provisions of this Agreement and in conformity with relevant provisions of the General Agreement on Tariffs and Trade, 1994.
- The objectives of this Agreement are:
  - (i) To promote through the expansion of trade the harmonious development of economic relations between India and Sri Lanka.
  - (ii) To promote fair conditions of competition for trade between India and Sri Lanka.
  - (iii) In the implementation of this Agreement the Contracting Parties shall pay due regard to the principle of reciprocity.
  - (iv) To contribute this way, by the removal of barriers to trade, to the harmonious development and expansion of world trade.

## The Objectives of the Agreement

- The Agreement seeks to establish a “Free Trade Area” in conformity with this Agreement and in conformity with the relevant provisions of GATT, 1994. This is far from being achieved as documented in various studies. For instance Mukherji et al (2003) found that 38 per cent of India’s bilateral exports to Sri Lanka in 2001-02 were subject to products contained in Sri Lanka’s Negative List while only 6 per cent of India’s imports from Sri Lanka were subject to products contained in its Negative List in the same year. Thus the attainment of a free trade area, which envisages that ‘substantially all trade’ (generally 90 per cent of the trade) be liberalized, has not been satisfied. Having stated this, it must be noted that in the spirit of non reciprocity between the two trading partners- one much larger in size, population and national income, (India) had put out a list of only 429 items in its Negative List while Sri Lanka had a much larger List of 1180 items.
- The first objective is to promote, through the expansion of trade, harmonious development of economic relations between the two countries. To understand this objective, we need to look into the flow of trade between India and Sri Lanka prior to
- the signing of the Agreement till to date. This has been presented in Figure 4 below.

## The Objectives of the Agreement



- Looking at the trend in Indo-Sri Lanka trade, we notice two distinct phases: (i) 1999-00 to 2005-06 and (ii) 2005-06 to 2008-09. During the first phase both the countries trade expanded briskly, with India’s imports from Sri Lanka rising faster than its exports. Consequently, the trade imbalance as reflected in export-import ratio, decreased from 11 in 1999-00 to 3.5 in 2005-06. However during the second phase India’s imports from Sri Lanka declined for the first time in 2006-07 and more perceptibly in 2008-09. India’s exports to Sri Lanka also declined for the first time in 2008-09, though not so drastically. Consequently, India’s export-import ratio of trade with Sri Lanka almost doubled from 3.5 in 2005-06 to 6.8 in 2008-09. This calls to question the “harmonious development” principle.

## The Objectives of the Agreement

- A second objective of the Agreement has been to promote fair conditions of competition for trade between India and Sri Lanka. In this context it must be noted that no competition policy has been invoked under the Agreement. Such a principle could be invoked under a more comprehensive agreement now being discussed on the table between the two countries. Monopolistic or monopsonist conditions at any end of the market could prevent the benefits of trade liberalization to reach the end user<sup>[1]</sup>.
- The third objective of the Agreement envisages that in the implementation of this Agreement the Contracting Parties shall pay due regard to the principle of reciprocity. It must be highlighted here that the principle invoked in the Agreement goes beyond reciprocity as the larger country has offered a longer phase out time for trade liberalization for the smaller neighbor as also accepted a much larger Negative List, in keeping with the protective concerns of its much smaller neighboring island economy.
- <sup>[1]</sup> There were reports that prices of cement imported from India to Sri Lanka did not decline in spite of tariff preferences offered on them. More analysis needs to be done to examine how the terms of trade between exporters and importers have changed following trade preferences.

## The Objectives of the Agreement

- The fourth and final objective is to the removal of barriers to trade and to the harmonious development and expansion of world trade. This objective however remains to be achieved as a number of non-tariff barriers in the nature of quotas, licensing, prohibitions of various types continue to act as impediments to bilateral trade.
- It is notable that the Sri Lanka Standards Institution (SLSI) has recognized India's Export Inspection Council's (EICs) inspection and certification for the purpose of Import Inspection Scheme of Sri Lanka being operated by SLSI covering 85 products, under a Memorandum of Understanding (MOU) signed on 26 December, 2002 which became operational from August 2004. A reciprocal MOU of SLSI with EIC for food products is pending.

### Expectations: Looking Ahead

- At the time of signing of the Agreement, there were deep apprehensions, particularly among stakeholders in Sri Lanka.
- In view of these apprehensions, it took nearly 15 months for both the countries to draw up their respective Negative Lists.
- Thus Sri Lanka drew up a long Negative List mainly to protect their agriculture, livestock, rubber and paper products, iron and steel, machinery and electrical items.
- India's Negative List sought to protect its garment, plastic and rubber manufacturers.

### Expectations: Looking Ahead

- The first six years of the operation of the ILFTA belied the pessimism of the doomsayers as bilateral trade expanded rapidly and in addition, foreign direct investments from India accelerated. This euphoria however was short lived.
- What then went wrong with ILFTA in the subsequent years?
- The answer in response is that Sri Lanka's exports to India was narrowly focused on vegetable oil and copper products which together, accounted for nearly 50 per cent of total Sri Lankan exports to India. These exports to India were not based on the country's comparative advantage, but on vastly differential external tariffs on these products and on raw materials for these products. In keeping with India's reform programme and in more recent years also to meet the threat of spiraling inflation on imported food and raw materials, India reduced its external tariffs on these products.
- As the tariff differential in the two countries' external market eroded, the competitiveness of Sri Lankan exporters to the Indian market through vastly diminished arbitrage opportunities no longer existed.

### Expectations: Looking Ahead

- One positive indirect consequence of ILFTA has however been the substantial increase in Indian investments to Sri Lanka has increased cumulatively from a mere US \$ 4 million in 1998 to US \$ 126 million in 2008. India is now the second largest investor in the country, exceeded only by Malaysia According to figures presented by the Indian Embassy in Colombo, the cumulative investment by India is even higher at US\$ 400 million. Another US\$ 300 million Indian investment approved by Board of Investment is in pipeline at various stages of investment. A major upshot of the FTA has been the beginnings of major Sri Lankan investments in India as well. If capital flows, mainly from India to Sri Lanka is factored in, the overall imbalance, taking both current and capital flows, is to some extent moderated.

### Expectations: Looking Ahead

- What lessons can we derive from a decade of operation of ILFTA?
- The position taken by the WIDER study many years back to work towards tariff equivalence comes to ones mind. Had the two countries' external tariff rates been harmonized, or a move towards a uniform external tariff been achieved, the opportunity towards trade deflection on the basis of arbitrage on external tariffs would have been eliminated.
- Second, while some products having high export potential have been included in Negative Lists, others, which *should in fact have been put under Negative Lists* have not so been included. (eg. Copper products and *vanaspati*).
- Third, it is important that raw materials and intermediate goods are not included in Negative Lists. If included, then products utilizing such raw materials should not be liberalized.

## Expectations: Looking Ahead

- Products having high potential trade should be taken out of the Negative Lists<sup>[1]</sup>.
- Mutual recognition agreements between India and Sri Lanka have remained non reciprocal in India's favour. A mutually reciprocal arrangement needs to be worked out.
- 
- While limitations have emerged in the operation of ILFTA in recent years, it is better to address them rather than allow it to stagnate since in spite of its limitations, *on a comparative analysis, as noted earlier, it continues to remain the best possible alternative for the two countries to expand their mutual trade.*
- Given the pace at which comprehensive economic partnership agreements including trade, investment and services are being worked out under different regional trading arrangements, a move towards a Comprehensive Partnership Agreement should not wait until all issues in ILFTA are sorted out. Such a delay will result in foregoing a first mover advantage in services trade agreement.
- <sup>[1]</sup> To illustrate, products with high export of Sri Lanka, but listed in India's Negative List are articles of vulcanized rubber, natural rubber, gaskets, washers and other seals, men's and boy's shirts of cotton etc. Similarly products having high export potential of India with Sri Lanka, but listed in Sri Lanka's Negative List include sugar refined, vehicles, other liquefied petroleum gases, goods and passenger vehicles, tobacco, etc.

● Thank you for  
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Comments and  
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