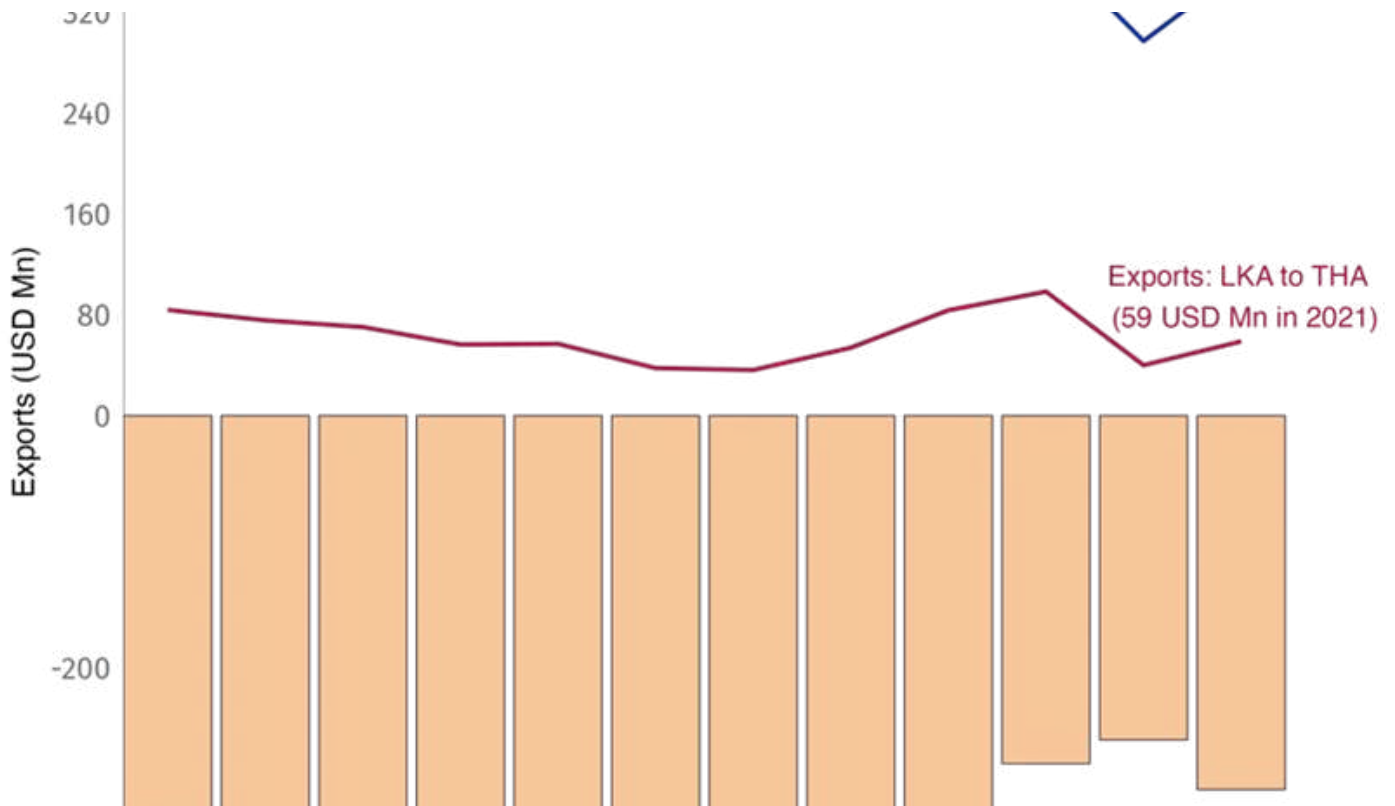




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Establishing bilateral trades: The economic case for a SL-Thailand FTA

15 May 2023 | BY Dr. Asanka Wijesinghe and Nilupulee Rathnayake



In 2019, only 6% of the tea imported by Thailand was from Sri Lanka. This low percentage can be attributed to the difference in preferences and Thailand's high tariffs of 90% on imported tea, which act as barriers to Sri Lanka's tea exports. Additionally, Thailand imposes up to 30% tariffs on nearly 120 product lines of wearing apparel.

These high tariffs for products with a comparative advantage are not exclusive to Sri Lanka. Thailand also faces higher tariffs for vehicles, rubber, and light electronics exports which Thailand exports competitively. This tariff structure hampers the bilateral trade of products with a higher comparative advantage for both the countries.

Despite these challenges, Sri Lanka and Thailand have expedited the process of signing a free trade agreement (FTA) to boost bilateral trade by threefold to United States Dollars (\$) 1.5 billion.

Existing trade is skewed towards Thailand

In the pre-Covid-19 pandemic period, Sri Lanka-Thailand bilateral trade was nearly \$ 500 million. The three-years period - i.e. 2017, 2018 and 2019 - average exports from Sri Lanka to Thailand were around \$ 62.9 million, while the exports from Thailand to Sri Lanka were \$ 416.8 million. In 2019, Thailand was the ninth largest import source for Sri Lanka, but Sri Lanka is only the 73rd largest import source for Thailand. The mismatch resulted in a bilateral trade deficit of \$ 353.9 million.

The existing exports from Sri Lanka to Thailand do not represent Sri Lanka's typical export basket. The contribution of traditional exports like ready-made garments, tea, rubber, and coconuts is relatively low, and gems, electrical equipment, wheat flour, and activated carbon contribute to a greater extent. Technically specified natural

rubber and latex are the top exports from Thailand which are essential raw materials in the value added rubber industry of Sri Lanka.

Effect of lowering tariffs on bilateral trade to zero

As estimated from partial equilibrium analysis, Sri Lanka will realise a 38% increase in exports to Thailand if the tariffs are reduced to zero (Figure 2). The wearing apparel sector would be the biggest beneficiary, with exports projected to increase by 251% from US \$ 6.4 million to US \$ 22.5 million. Figure 3A provides the top 10 exports by Sri Lanka benefitting from a tariff removal by Thailand. The export effect for Thailand will be 27.8% and Thailand's rubber and plastic products will be increased by 71.9% or US \$ 35.4 million. Products such as smoked sheets of rubber and natural latex would benefit the most from tariff elimination, as shown in Figure 3B.

Assuming an immediate phasing out of the existing tariffs, a FTA would increase bilateral trade to \$ 619.6 million by 29.1%. This increase falls short of the ambitious goal of a threefold increase in bilateral trade, at least in the short run.

However, partial equilibrium analysis does not estimate the trade gains from new product innovations due to foreign direct investment movements. The estimates also do not account for trade effects through input-output linkages and the magnification of the tariff effects along the value chains. However, tariff phasing out takes time, and FTA coverages are less than 100%.

Maximising trade gains through offensive lists

An offensive list contains products for which a country has a comparative advantage, capacity for expansion, and a favourable tariff from the importing country. There are 154 such products for Sri Lanka. Notably, 81% of the \$ 27.6 million export gain from a

FTA comes from these 154 product lines. Similarly, 69% of Thailand's export gains to Sri Lanka in a FTA come from 147 products identified for the offensive list.

Once ordered by the estimated export gains, nine out of the top 10 products of Sri Lanka's offensive list are from the wearing apparel sector. For Thailand, vital offensive products are rubber, electric equipment like air conditioners and refrigerators, and motor vehicles for goods transportation.

Challenges and the way forward

Applying tariff cuts for all the products in the offensive lists is a challenge. Thailand's high tariffs for tea and ready-made exports indicate its protectionist intent. Likewise, Sri Lanka might prefer to keep tariffs on rubber products. Significant political manoeuvring and delicate negotiations will be required to bring the coverage of the FTA to a satisfactory level. Secondly, a FTA will widen Sri Lanka's trade deficit with Thailand by 26% (Figure 4). Although a trade deficit is not necessarily detrimental, it does present a short-term challenge due to the increased US dollar outflow.

A possible solution is tariff elimination for the products in bilateral value chains. Sri Lanka uses Thailand's rubber and textile products to produce finished goods. If Thailand removes tariffs for these finished products, increased exports will demand more raw materials. Sri Lanka can reciprocate by eliminating the tariffs on raw materials. The phasing in of the FTA, and accounting for the required adjustments, will also increase the political feasibility.

Strengthening bilateral trade ties with Thailand offers additional benefits to Sri Lanka. A FTA provides an opportunity to join electrical equipment manufacturing related value chains and a gateway to Association of Southeast Asian Nations economies. Thus, Sri Lanka should negotiate a comprehensive trade agreement with investment

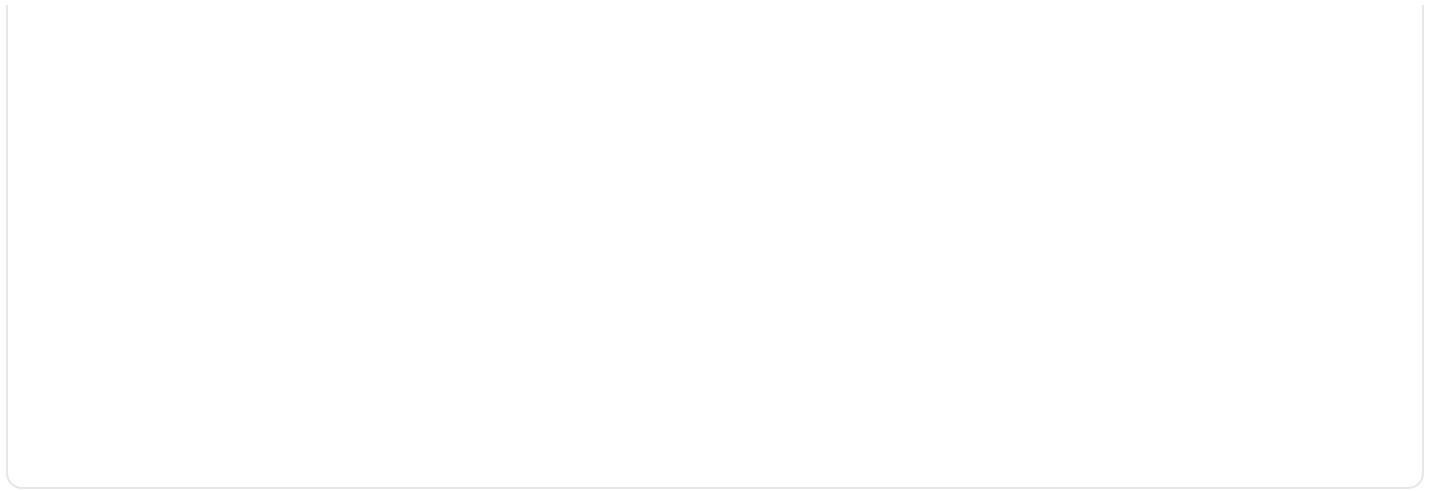
promotion, trade facilitation, and competition laws. Thailand can leverage Sri Lanka's position as a distributional hub for regional exports.

(Wijesinghe is a Research Fellow at the Institute of Policy Studies [IPS]. He can be contacted at asanka@ips.lk. Rathnayake is a Research Assistant at the IPS. She can be contacted at nilupulee@ips.lk.)

The views and opinions expressed in this article are those of the author, and do not necessarily reflect those of this publication.

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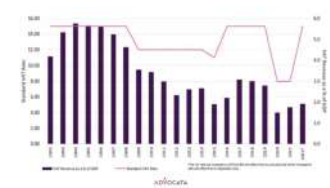
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