The Future of Economic & Other Relations between Sri Lanka and India

1.2 trillion dollar GDP, 1.1 billion people: How best can we grow with India?

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Introduction

India is one of the world's most dynamic economies and attractive markets with which Sri Lanka continues to have strong relations by reason of proximity and history. India's relations with Sri Lanka have, for the most part, been friendly and are probably the best that it enjoys with its non-micro-state neighbors. India's first bilateral free trade agreement (FTA) was with Sri Lanka and resulted in considerable growth in trade and investment, though not without some frictions, which for the most part have been addressed. The Indian economy, which grew at 5.3 percent even in the fourth quarter of 2008 (when Sri Lanka's other export destinations were experiencing negative growth) and is expected to grow at around 7 percent in 2009, is likely to be among the least affected by the global economic crisis. This suggests significant benefits to both countries from building on the existing foundation of a bilateral disciplinary framework in trade in goods. Sri Lanka can benefit from a larger market that will allow the realization of economies of scale, the ability to integrate into sustainable and low-cost value chains and greater investment. India can benefit from demonstrating a model of a productive partnership with a neighbor, which if emulated has potential to generate robust regional growth and ameliorate political friction.

Trade in Goods

Sri Lanka's trade pattern in goods changed since the 1990s and particularly after Indo-Lanka FTA. Sri Lanka's exports to India reached USD 515.3 million in 2007, an increase of 838 percent over seven years, compared with a total export growth of 47.5 percent (Table 1). India was the third largest destination for Sri Lanka's exports by 2007.

Table 1: Destinations of Sri Lanka's Exports: Top 5 Countries in 2007

Country	2000 USD mn(a)	2007 USD mn	% Change
USA	2075	1,970	-5.1
UK	697	1,018	46.0
India	55	515.3	838.0
Germany	218	437.9	101.0
Belgium	147	400.1	171.3
Total Exports	5,248	7,740	47.5

Source: Central Bank of Sri Lanka

given for comparison only.

Sri Lanka's imports from India also recorded rapid growth, reaching USD 2,610 million by 2007 (Table 2). Imports grew by 359.5 percent in 2000-2007, compared with overall growth of 63.2 percent. India has been the largest source of imports to Sri Lanka since 1997. Trade expansion requires liberalization by both trading partners. This condition, to a large extent was satisfied in the 1990s with the initiation of trade policy reforms in India. The impetus for trade expansion however, also came from bilateral and multilateral trade agreements. The South Asian Preferential Agreement (SAPTA) of 1997 provided limited scope for trade expansion under preferential tariffs among the South Asian countries. The Indo-Lanka FTA was negotiated in 1998 and implemented in 2000. The FTA increased the salience of the subject even prior to coming into operation, and significantly reduced tariffs.

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Table 2: Origin of Sri Lanka's Imports: Top 5 Countries in 2007			
Country	2000 USD mn(a)	2007 USD mn	% Change
India	568	2610	359.5
Singapore	469	1119	138.2
China	370	924	150.0
Iran	192	844	338.8
Hong Kong	488	725	48.4
Total imports	6,923	11,301	63.2
Source: Central Bank of Sri Lanka			
comparison only.			

Total Sri Lanka-India trade (exports plus imports) increased from USD 671.6 million in 2001 to USD 3,265.2 million in 2007 (Figure 1). Export volumes increasing slower than imports, the bilateral trade balance increased in favor of India from USD 531 million in 2001 to USD 2,234 million in 2007. Nevertheless, Sri Lanka's exports to India grew faster than imports during the initial period of 2001-2005 (Figure 2). During 2006-2007 the deficit increased as a result of increased petroleum imports and decreased exports of vanaspati and copper.

After 2000 exports to India diversified as well. By 2007, major exports to India included insulated wires and cables, vegetable fats and oils, articles of stone, plaster, cement, rubber and articles thereof. This was potential export expansion being limited by port and quota restrictions and the implementation of the rule of origin. Many of these issues were discussed at the Comprehensive Economic Partnership Agreement (CEPA) negotiations without which Sri Lanka would have ended up with no forum even to discuss the bilateral issues.

Figure 1: Trade between India and Sri Lanka 2001-2007

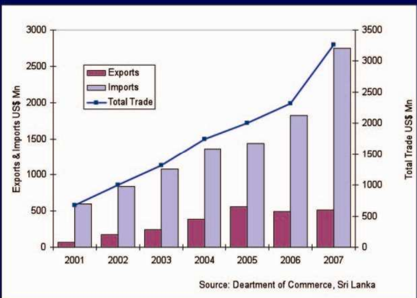
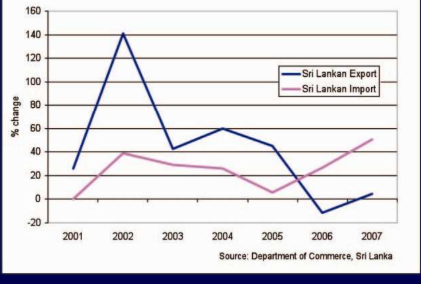


Figure 2: Export and Import Growth: Annual Percentage Change

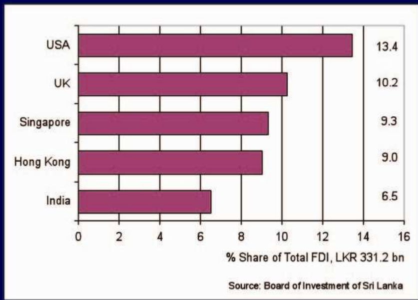


The rapid growth of imports from India was, however, not necessarily a result of the FTA. Sri Lanka was already sourcing imports from India even prior to the implementation of the FTA. Even after the FTA, imports such as motor vehicles, petroleum products, agricultural products and paper products, which were in the negative list, grew as part of normal trade. According to the Department of Commerce, Sri Lanka's imports under the FTA were only about 14 percent of the country's total imports from India in 2007. This suggests that imports from India would have increased even without the FTA.

Investment

Sri Lanka has become an attractive destination for Indian Foreign Direct Investment (FDI), particularly since 2000. India was one of the top-five countries investing in Sri Lanka by the end of 2007, accounting for 6.5 percent of the total FDI stock of LKR 331.2 billion (Figure 3). The Board of Investment of Sri Lanka (BOI) states that over half of Indian investments in the SAARC region are located in Sri Lanka. The period after 2000 was even more important because investment from India grew by an average of USD 33 million per annum, accounting for 16 percent of total FDI flows during 2001-2007.

Figure 3: FDI Top Five Countries Investing in Sri Lanka



Policy reforms, since 1978 in Sri Lanka and since 1991 in India, had created conditions conducive to bilateral trade and investment flows. The increase in Indian FDI may be partially attributed to the FTA. It increased the scope for the expansion of trade in goods between the two countries, and thereby broadened the scope for investment expansion to exploit the advantages of bilateral trade between India and Sri Lanka. Besides, Sri Lanka had already entered into a bilateral Investment Promotion and Protection Agreement (IPPA) with India to promote foreign investment in 1997.

By 2003, the two countries were making preparations for the proposed CEPA, which was on a fast track at that time. The process of bilateral economic integration was to be expanded to include trade in services and investment. However, even without an agreement as such, the higher trade profile of Sri Lanka resulting from the bilateral agreements and negotiations appear to have increased Indian FDI to Sri Lanka. The BOI also facilitated greater FDI flows from India.

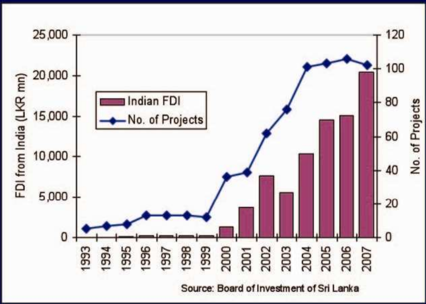
Compare this with the 1990s, when there were only 12 Indian projects with a total investment of LKR 177 million. Indian FDI (the foreign country shares only, excluding the local contribution) increased to over LKR 20 billion under 90 projects by the end of 2007.

The post-2000 expansion changed the sectoral distribution of Indian FDI changed remarkably. Indian FDI is now mostly in the service sector (63 percent of the total). In 2000, the service-sector share was only 30 percent; there was no service-sector investment from India in 1990. This change was due to fast growth of Indian investments in services such as health, education, fuel distribution, hotel industry, tourism, IT training, computer software and professional services.

By 2007, in addition to the service sector, Indian investment was present in the fabricated metal and food industries. The FTA provided opportunities for Indian investors to produce in Sri Lanka for export to India. For instance, vanaspati and copper exports grew rapidly for this reason, competing with Indian domestic producers. These exports were later restricted due to domestic pressures in India.

Sri Lankan firms have made investments in India, though systematic data is difficult to obtain, in the absence of a dedicated investment agency in India. The recorded investments include those in furniture and food manufacturing and in hotel services.

Figure 4: Cumulative Increase in FDI from India to Sri Lanka 1993-2007 (excluding local share of investment)



Trade in Services

Bilateral Tourist Flows

India has emerged as Sri Lanka's biggest market for tourist arrivals ahead of the UK, Germany, Maldives and Australia (Table 3). During 2002-2007 tourist arrivals from India grew rapidly at 20.9 percent per annum (CAGR). Tourist arrivals from Western countries grew slowly, due to security perceptions. Improved bilateral relations, including unilateral visa liberalization by Sri Lanka, contributed to the rapid growth of Indian arrivals.

Table 3: Top Five Tourist Arrival Countries to Sri Lanka

	2007		2002 - 2007 CAGR
	No.of tourists	share of total (%)	
India	106,067	21.5	20.9
UK	94,060	19.0	5.6
Germany	35,042	7.1	-8.7
Maldives	29,539	6.0	21.9
Australia	20,241	4.1	9.9
Total	494,008	100	6.6

Source: Annual Statistical Report of Sri Lanka Tourism 2007

Sri Lanka is India's fifth largest source market for tourism (Table 4), while pilgrimage appears to be the main reason. Sri Lankans visiting India constitute a relatively small share (3.5 percent) of the 4.5 million tourists entering India every year, but in absolute numbers, they still outnumber Indians visiting Sri Lanka. Sri Lankan tourist arrivals in India have been growing only at 3.6 percent per annum during 2001-2006.

Table 4: India's Top Five Tourist Source Markets

	2006		2001 - 2006 CAGR
	No.of tourists	share of total (%)	
UK	734,240	16.5	9.2
USA	696,739	15.7	12.3
Canada	176,567	4.0	13.2
France	175,345	3.9	9.1
Sri Lanka	154,813	3.5	3.1
Total	4,447,16	100	12.9

Source: Ministry of Tourism, India

Port and Airport Services

Despite the limited availability of detailed information, the evidence suggests that there are many other areas in which Indo-Lanka economic relations continued to strengthen. The Port of Colombo is the main transshipment hub for the Southern Asian region. About 70 percent of total transshipment cargo from India is handled by the Colombo Port (Venkat Narayan, 2008). Relative efficiency of the port has made transshipment via Colombo cost- and time-effective.

Despite recent cutbacks and problems, Sri Lankan Airlines continues to be the largest foreign carrier into India. Transit passengers of which the majority from India increased to 46 percent in 2008 from 28 percent in 2003-04 when the market was liberalized as part of the CEPA negotiations (Trade Arabia, 2008; see also, Samarajiva, 2006).

Health and Education Services

Trade in health and education services between Sri Lanka and India has developed as one-way transactions, with Sri Lankans traveling to India for health and education services, and Indians not reciprocating. The factors underlying the export of health and education services from India to Sri Lanka are supply constraints, low costs and proximity. For many middle income Sri Lankans, India is the preferred destination for higher education as well as for medical treatment, due to inadequate supply and quality resulting from government prohibitions of private participation in education and health industries. The wealthiest Sri Lankans can obtain these services from Singapore, Europe and the US, but India is the only option for middle-income groups.

Managing Relations in a Disciplining Framework

The India-Sri Lanka economic relationship has transformed and developed rapidly in all aspects in the past decade. Those who seek to draw negative conclusions about increasing trade deficits (seen as a loss to the country) and increasing FDI inflows (seen as increasing foreign control), fail to appreciate that not importing from India would have carried greater costs. If not for Indian investments, Sri Lanka may have an even greater trade deficit than what already exists.

Grow with Bilateral Relations

There is nothing particularly good or bad about a trade surplus or deficit with a specific country, contrary to populist mercantilist concerns. If Sri Lankan firms are buying low-cost inputs from India to make their higher-value-added exports more competitive or if Indian imports are replacing higher-cost imports from other countries, they are good. Because these conditions are satisfied, increased trade with India, even with increasing deficits is a good thing.

The same is true for trade in services. While Sri Lanka has much scope for exporting services to India, thereby contributing to economic growth, employment and the balance of payments, it is necessary to acknowledge the reciprocal importing of services from India as well. Besides, importing of services such as health and education at a reasonably low cost is beneficial to the lower- and middle-income Sri Lankans who face domestic supply constraints.

Rule-Based Bilateral Regime
Lack of a rule-based regime to manage bilateral relations is problem, especially for small states. Rule-based regimes are superior to anarchy, even when there is substantial asymmetry of power among the parties and even when the rules are not perfect. Of course, a rule-based regime that is entered into on the basis of principles of fairness and mutual respect, by parties that are equally endowed with knowledge and power, using means of negotiation that are equitable and non-violent, would be best.

In the absence of progress on multilateral and plurilateral (regional) frameworks, the pragmatic, best-available option available to Sri Lanka is a bilateral agreement within a rule-based disciplining framework because there is little forward movement in multilateral agreements such as SAFTA. It is superior to a power-oriented regime, which is what currently exists for economic relations not governed by the FTA, such as Indo-Lanka services trade.

What is truly novel and significant in the proposed Comprehensive Economic Partnership Agreement (CEPA) is the addition of disciplinary frameworks for trade in services and for investment and the strengthening of dispute-resolution procedures. The opposition that has emerged is from goods traders who seek to hold hostage new sectors in which they have no stake. A disciplinary framework is most necessary with services where there are no tariffs to reduce, only non-tariff barriers to remove. In the absence of a disciplinary framework, everything has to be negotiated case-by-case.

The choice available to Sri Lanka is clear. Sri Lanka should move ahead to adopt CEPA, the disciplining framework already negotiated by both parties to open up avenues for service trade, advance good trade and enable investment flows.

Policy Recommendations

1. Sri Lanka's rapid economic development will be best served by strengthening and managing bilateral economic relations with India for the following reasons:

a) India has now become the fastest growing economy in South Asia with one of the biggest markets in the world, second to China only

b) India is one of the growing economies in the world with the potential to manage its growth momentum in the face of current global economic crisis

c) Sri Lanka and India has maintained the best economic and political relations in the South Asian region (in spite of short-term frictions) which can be built upon for a lasting and mutually beneficial relationship.

2. Economic relations with India should be strengthened within a rule-based liberalized trade regime which can provide policy environment conducive for strengthened economic relations with clearly defined rules. This would avoid the frictions associated with ad hoc problem solving. This is especially important for services, where there are no tariffs to reduce, only non-tariff barriers to remove.

3. Given India is negotiating and implementing a slew of bilateral trade agreements with much larger economies such as Japan and the European Union, it would be unwise to delay or reopen the already negotiated CEPA. A commitment should be given to set up a time-bound mechanism to examine and resolve any problems goods exporters may have experienced in the first years of the FTA. The opponents of CEPA should be made aware that their complaints relate to the already existing FTA which is merely one chapter of the CEPA.

4. The Report of the Joint Study Group on the CEPA made detailed recommendations of trust building actions that could be taken prior to and in parallel with the implementation of CEPA. It would be wise, even at this late stage, to undertake those actions.

About the Author

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Dr. Samarajiva is Chair and CEO of LIRNE*asia*. He is Senior Advisor to Sarvodaya (Sri Lanka's leading Community Based Organization) and serves on the ICT Subcommittee of the Ceylon Chamber of Commerce and on the Board of the Lanka Software Foundation. Dr. Samarajiva was Team Leader at the Ministry for Economic Reform, Science and Technology (2002-04) responsible for infrastructure reforms, including participation in the design of the e Sri Lanka Initiative. He was Director General of Telecommunications in Sri Lanka (1998-99) and a member of the intergovernmental Joint Study Group on the India-Sri Lanka Comprehensive Economic Partnership Agreement (2003) and chaired the GATS Advisory Committee of the Department of Commerce, Sri Lanka (2002-2004).

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