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REGIONAL VALUE CHAINS

BACKGROUND PAPER

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India FTA and the Sri Lanka – Pakistan FTA**

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Institute of Policy Studies

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Introduction

Since the implementation of Sri Lanka's Free Trade Agreements (FTAs) with India and Pakistan, there have been markedly different impacts on its bilateral trade with the two countries.

The India – Sri Lanka Free Trade Agreement (ISFTA) was signed in December 1998 and was among the first attempts to promote trade liberalization in South Asia. It was India's first bilateral free trade agreement and resulted in substantial growth in trade between the two countries after becoming operational in March 2000.

An analysis of sectoral growth that follows below shows that within the first two years following implementation of the Agreement, several sectors experienced over 100% growth, including industries such as chemical product manufacturing, cement manufacturing, and pearl harvesting. Among Sri Lanka's key exports, textile articles grew noticeably by 370%. Nonetheless, some industries did suffer negative growth.

Nonetheless, the development-oriented impacts of the ISFTA have been fairly limited. Despite Indian investment in Sri Lanka increasing substantially following the inception of the Agreement, there has not been a proportionate generation of employment in Sri Lanka. For example, of the 5,900 jobs created as a result of Indian investment projects, 1,500 were simply reallocation of labour from one company to another.

When examining the Pakistan – Sri Lanka Free Trade Agreement (PSFTA), the impacts on Sri Lanka's economy are smaller still. Sri Lanka was eager to create a free trade agreement with the nation, particularly after the significant market access Sri Lanka received following the FTA signed with India. Accordingly, the PSFTA was signed in 2002 and came into implementation in 2005.

However, the impact of the PSFTA on the value of Sri Lanka's exports to Pakistan is negligible. The value of Sri Lanka's exports to Pakistan did not grow considerably but instead fluctuated over the 2006 to 2010 period. The value of exports to Pakistan as a percentage of Sri Lanka's total exports remained throughout the 5 year period following the implementation of the Agreement and failed to rise above 1%, indicating that Pakistan is not a significant destination for Sri Lankan exports.

What follows is a brief analysis of the two agreements. The paper aims to address the impact of the two FTAs on Sri Lanka's economy through an evaluation of key exports and imports, investment projects, and negotiating experiences.

India-Sri Lanka Free Trade Agreement

The development-oriented impacts of the ISFTA have been fairly limited. Despite Indian investment in Sri Lanka increasing substantially following the inception of the Agreement, there has not been a proportionate generation of employment in Sri Lanka.

To illustrate, from 1978 – 1995, India contributed a mere 1.2 per cent of total FDI in Sri Lanka, whereas after the implementation of the ISFTA, foreign investment from India rose significantly and has reached a point where India is currently Sri Lanka's second biggest foreign investor¹. However, the number of jobs created as a result of the signing of the ISFTA has been disproportionately small. Despite the Board of Investment (BOI) of Sri Lanka reporting the creation of 5,900 jobs as a result of Indian investment from 1993 – 2007, many of these jobs were simply reallocations of previously existing jobs. For example, 1,500 employees of the Ceylon Petroleum Corporation were transferred to retail outlets of Indian oil firms. Rather than the generation of new jobs, this was more an exercise in the reallocation of labour.

Furthermore, a rigorous analysis of the impact of the ISFTA on job creation in Sri Lanka has not been conducted. Questions regarding the number of overall jobs created and lost, how many new jobs were created as a result of the loss of other jobs, whether Sri Lankans or Indians were the primary

¹ Kelegama, S., 2009, 'India-Sri Lanka Bilateral Free Trade Agreement: Sri Lankan Perspective and Implications', Presentation to the 'Asian Regional Workshop on Free Trade Agreements: Towards Inclusive Trade Policies in Post-Crisis Asia', jointly organized by IDEAS, GSEI, & ITD, Bangkok, 8-9 December, available: [networkideas.org/ideasact/dec09/ppt/Saman_Kelegama.ppt].

beneficiaries of this employment generation, and the types and quality of employment arising from the Agreement have not been answered by existing literature on the ILFTA.

The India-Sri Lanka Free Trade Agreement was signed in December 1998 and was among the first attempts to promote trade liberalization in South Asia. It was India's first bilateral free trade agreement and resulted in substantial growth in trade between the two countries after becoming operational in March 2000.

By this point, India had committed to a 100% tariff cut for 1,351 items. By March 2003, India had concluded a tariff phase out for 2,797 items, with these items having 100% preference.² This was conducted in two stages, with the applicable tariffs reaching zero by the end of the phase out. Following this reduction of tariffs in 2003, Sri Lankan exports to India surged by over 200% in the two years that followed.

India's commitments also included a tariff rate quota for tea, reaching 50% preferential market access by 2000 with a MFN rate being applied to an amount of 15mn kg per year. Garments also enjoyed a 50% preferential market access for an amount of 8mn pieces, of which a minimum of 6mn pieces must contain Indian fabric. The requirement that no category of garments can go beyond an amount of 1.5 million pieces a year was made during the negotiation process. A Margin of Preference (MOP) was applied to textiles, which enjoyed a 25% preferential duty margin for 553 textile products without any limit on quantity. The negative list includes 429 items, including 231 garment items. India's Rules of Origin are such that items must have 35% domestic value added or 25% Sri Lankan value added if using 10% Indian inputs.

Sri Lanka's commitments to India are different. Sri Lanka committed to a 100% tariff cut for 319 items (6-digit HS code) by March 2000, and implemented a tariff phase out in the following manner: in March 2000, Sri Lanka committed to a 50% reduction on 889 items, followed by a 70% reduction one year later, a 90% reduction two years later, and a 100% reduction (implying duty-free status) three years later. By March 2003, the remaining 2,779 items would experience a reduction of at least 35%, followed by a reduction of at least 70% three years later, and a reduction of at least 100% two years later (by 2008).

² Yatawara, Ravindra A., 2007, *Exploiting Sri Lanka's Free Trade Agreements with India and Pakistan: An Exporter's Perspective*, South Asia Economic Journal, Sage Publications.

Sri Lanka's Negative List includes 1,220 items, and its Rules of Origin state that 35% of items must be domestic value-added or 25% Indian value-added if using 10% Sri Lankan inputs.

In an analysis³ conducted in 2007 of Sri Lanka's trade with India, specific items were allocated a number of preference points based on competitive advantage. The analysis uncovered that 100 preference points (the maximum number possible) were awarded each to sunflower seed, peanut and palm oil, sugar, coffee, wheat, sausages, motorcycles, and motor cars. However, out of these nine products, only sausages, palm oil, and vegetable oil were exported to India. The remaining 100-point products were not at all exported to India. The analysis also examined the value of these preferred items and concluded that the only items worth more than \$1 million of exports were cloves, pepper, palm oil, and cardamom, which as of 2005, contributed the following in terms of exports to India: \$16.50Mn, \$10.79Mn, \$5.21Mn, \$3.72Mn.

Despite exporting 3,173 products (6-digit HS level) around the world, Sri Lanka exports only 887 products to India. Yatawara (2007) shows that Sri Lanka exports only 121 'High Preference Point goods' to India while exporting 578 items of the same preference globally. Yatawara (2007) argues that, while Sri Lanka has the capacity to produce these 'High Preference Point' products, it has yet to fully exploit the Indian market. Sri Lanka's top 50 exports to India in 2005 ranked by value consist of copper products, animal fats, vegetable oils, aluminum, pharmaceuticals, cloves, pepper, nutmeg, scrap metal and paper, diamonds, rubber products, tea, wall tiles, wooden furniture, and white goods such as air conditioners and refrigerators.

Following the 100% tariff reduction in March 2003, translated into complete free trade for 2,797 items, trade between the two countries surged. Sri Lanka's exports enjoyed an increase of 107% from \$245 million in 2003 to \$506 million in 2006. However, this growth came primarily from a handful of items, including animal fats, vegetable oils, copper and aluminum products, and pharmaceuticals, contributing 77% of the surge in exports. A look at these products indicates that exporters are predominantly focusing on conducting light processing on imported goods. The case of vanaspati (a type of vegetable oil) sparked some controversy, as it was established that Indian investors were setting up processing plants in Sri Lanka that converted imported crude palm oil into vanaspati and then exporting this to

³ Yatawara, Ravindra A., 2007, *Exploiting Sri Lanka's Free Trade Agreements with India and Pakistan: An Exporter's Perspective*, South Asia Economic Journal, Sage Publications.

India, in order to avoid the 80% Indian tariff rate on the product (whereas Sri Lankan tariffs amounted to only 15%). Processing palm oil into vanaspati in Sri Lanka made further financial sense to these Indian exporters because the product enjoyed a zero duty rate under the ISFTA.

In terms of employment generation, vanaspati processing offered limited benefits and did not offer large-scale employment to Sri Lankans. Following protests by vanaspati manufacturers in India who complained about the Sri Lankan product flooding their markets, the Indian government imposed a quota and a canalization policy on this import, leading to many of the vanaspati manufacturers in Sri Lanka to shut down. During such closure, it was estimated that close to 4,000 jobs were at stake.⁴

Impact on Trade

Table 1: Top 5 Exports to India

1999		2005		2011	
Product	Value (SL Rupees)	Product	Value (SL Rupees)	Product	Value (SL Rupees)
Whole pepper	695 million	Vegetable fats and oils	12 billion	Animal feed	5.2 billion
Arecanuts	382 million	Refined copper and copper alloys	7.9 billion	Insulated wires & cables	4.7 billion
Scrap iron	272 million	Copper wire	4.1 billion	Cloves	3.8 billion
Dried fruit	214 million	Aluminum wire	3.1 billion	Waste & scrap paper	3.2 billion
Cloves	199 million	Antibiotics	2.2 billion	Garments	3.2 billion

Source: Calculated using data from the Department of Commerce, Sri Lanka

⁴ Kelegama, S. and Indra Nath Mukherji, 2007, *India – Sri Lanka Bilateral Free Trade Agreement: Six Years Performance and Beyond*, RIS Discussion Papers, New Delhi: RIS.

The above table attempts to gauge the impact of the ISFTA on Sri Lanka's top exports to India. Data was compiled for the following years: 1999 (the year immediately before the implementation of the agreement), 2005 (two years after India implements full liberalization), and 2011 (the year for which the latest data was available). One can see that in 2005, following the year the ISFTA was put into operation, vegetable fats and oils were the prime export, followed by copper products and pharmaceutical goods. One reason why vegetable oils were such a key export in 2005 may rely on the high quantity of exports of Vanaspati, a type of vegetable oil, for which tariff concessions were made under the ISFTA.

Table 2: Top 5 Imports from India

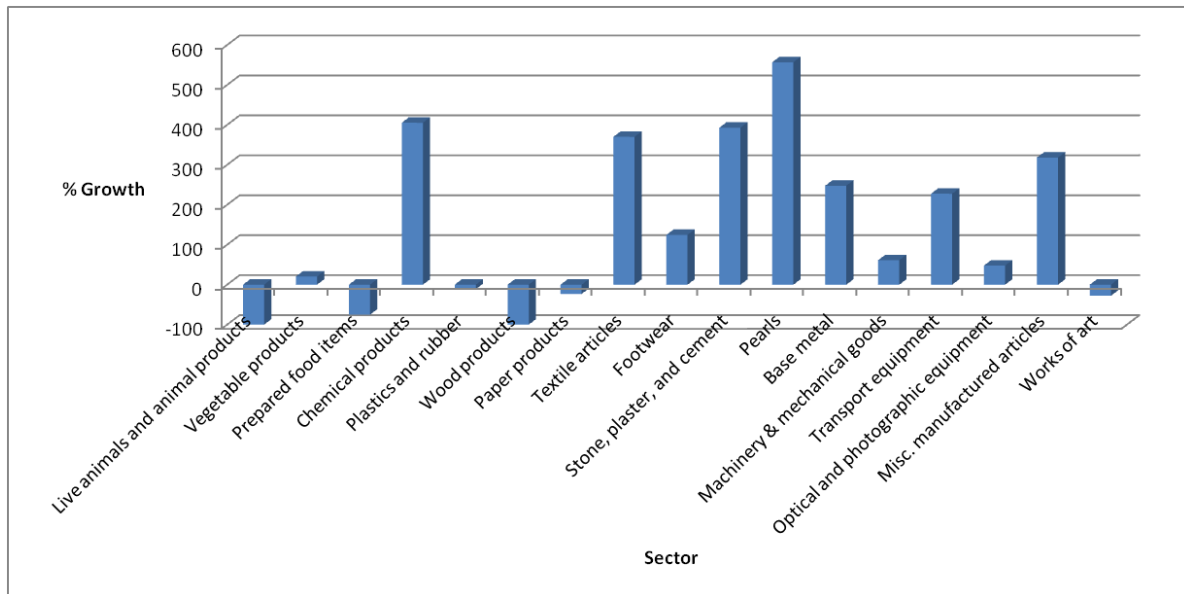
1999		2005		2011	
Product	Value (SL Rupees)	Product	Value (SL Rupees)	Product	Value (SL Rupees)
Lentils	2.1 billion	Refined petroleum oil	16 billion	Gas oil and diesel	47 billion
Ayurvedic medicine	1.4 billion	Motorcycles	8 billion	White cane sugar	35 billion
Motor cars	1.3 billion	Motor cars	6.3 billion	Petrol	32 billion
Milled rice	1.3 billion	Medicaments	5.3 billion	Motorcycles	19 billion
Pepper	1.2 billion	Crude petroleum oil	4.1 billion	Auto-trishaws	18.8 billion

Source: Calculated using data from the Department of Commerce, Sri Lanka

The above table shows the top 5 imports from India for the same years as previously mentioned. One may note that, following the implementation of the agreement, petroleum products and motor vehicles have become among the top imports to Sri Lanka in 2005 and 2011. This is potentially due to the tariff concessions made in the ISFTA that promote the importing of these items.

Sectoral Analysis of ISFTA

Figure 1: Impact of ISFTA on Sri Lankan Exports to India (2000-01 to 2001-02)



Source: Mukherji, Indra Nath, Tilani Jayawardhana, and Saman Kelegama, 2002, *Indo-Sri Lanka Free Trade Agreement: An Assessment of Potential and Impact*.

The above graph shows the percentage growth from 2000-01 to 2001-02 in Sri Lankan exports to India. One can see that most sectors experienced growth above 100%, with industries such as chemical product manufacturing, cement manufacturing, and pearl harvesting reaching above 300% growth. Nonetheless, several industries did suffer negative growth, including the exports of live animals and animal products, prepared food items, and wood products contracting by 100%, 75%, and 100%, respectively. Among Sri Lanka's key exports, textile articles grew noticeably by 370%.

Special and Differential Treatment under the ISFTA

Considering the substantial asymmetry between the economies of the two countries, key allowances were made to help Sri Lanka. Among them, a more extensive negative list was created for Sri Lanka to help its economy protect its most sensitive industries, including agriculture and livestock items, rubber products, paper products, iron and steel, machinery, and electrical items. Sri Lanka's negative list

features 1,180 items (or tariff lines), whereas India’s numbers only 429 items. India’s negative list includes those items which are most sensitive to its own industries, including garments, plastic, and rubber products.

In addition, Sri Lanka was granted a much longer period for liberalization of its tariff lines, as shown in the below table. A period of eight years was given to Sri Lanka to phase out its tariffs, while India was given a period of only three years to do the same. Obligations regarding duty concessions for Sri Lanka were split into three stages, with 35% at the time of implementation of the agreement, 70% in 2006, and 100% in 2008. India, on the other hand, was to grant 100% of its duty concessions in 2003.⁵

Table 3: Tariff Phasing Out Period and Duty Concessions

Tariff Phasing Out List	Period	Duty Concession		
India	3 years	100% in March 2003		
Sri Lanka	8 years	35% At present	70% in March 2006	100% in March 2008

Source: Board of Investment of Sri Lanka, “Services Provided by BOI: Indo-Sri Lanka FTA,” available [http://www.investsrilanka.com/international_agreement/indo_sri_lanka_fta_agreement.html#1.3].

Furthermore, the Rules of Origin (ROO) criteria are more flexible for Sri Lanka. Items that are produced entirely from local sources, such as tea, fish, and certain spices⁶, are permitted duty-free concessions as long as they are not on India’s negative list.

Tariff concessions under these ROO rules, along with other concessions offered under the ISFTA, have encouraged several key industries in Sri Lanka to thrive. Some industries that were already established prior to the ISFTA, such as the processing of spices and manufacturing of garments, saw a surge in

⁵ Board of Investment of Sri Lanka, “Services Provided by BOI: Indo-Sri Lanka FTA,” available [http://www.investsrilanka.com/international_agreement/indo_sri_lanka_fta_agreement.html#1.3].

⁶ Nonetheless, pepper has been a contentious item that has seen Indian authorities demand a cap on imports of the item to 2,000 metric tonnes per annum, down from the 6,000 metric tonnes per annum that were being shipped from Sri Lanka to India as of 2007 (Kelegama and Mukherji 2007).

exports to India. Sri Lanka's exports to India of cloves experienced almost a 20-fold increase from 1999 to 2011, from LKR 199 million to LKR 3.8 billion.⁷ Garments exports, which has risen in prominence in terms of exports to India and was among Sri Lanka's top five exports to the country as of 2011, recorded a value of LKR 3.2 billion of exports to India in 2011.⁸

On the other hand, industries which were not particularly well-established prior to the ISFTA have also experienced a surge in growth. The exporting of animal feed, insulated wires and cables, and waste and scrap paper were among the top five exports to India as of 2011 and recorded export revenue of LKR 5.2 billion, 4.7 billion, and 3.2 billion in 2011, respectively.⁹

Extensions of the ISFTA to Areas beyond Trade in Goods

In addition to increases in the exports of goods, the ISFTA has also led to an increase in the number of Indian investments in Sri Lanka. From 1998 to 2008, the value of these investments jumped from US\$ 1.4 million to US\$ 125.9 million, contributing to 14 per cent of total foreign direct investment in Sri Lanka.¹⁰ Furthermore, 63 per cent of these Indian investments have been in the services sector, an area which has seen a significant expansion following the implementation of the ISFTA. Companies such as Bharti Airtel, Apollo Hospitals, Lanka Oil Company, Taj Hotels, and Jet Airways have contributed to the 70 Indian investment projects that had been set up as of 2007 and which were employing 6,747 people at the time in Sri Lanka. Several Sri Lankan IT companies have ventured into the Indian market, providing internet-related services (as in the case of Interblocks providing services to Indian banks) and mobile phone services (as in the case of Microimage providing Tamil sms services to Airtel). Tourism companies based in Sri Lanka, including Aitken Spence and Jetwing, have begun operations in India.¹¹

The ISFTA has also led to better connectivity with India, resulting in an expansion in the number of flights and tourist arrivals from the northerly neighbour. As of 2011, the Department of Immigration and Emigration of Sri Lanka registered 171,374 arrivals from India, translating to 20 per cent of all tourist

⁷ Calculated using data from the Department of Commerce, Sri Lanka.

⁸ Calculated using data from the Department of Commerce, Sri Lanka.

⁹ Calculated using data from the Department of Commerce, Sri Lanka.

¹⁰ Daniel, Devan, (undated), "Indo-Lanka FTA is 10 Years Old," *The Island Online*, available: [<http://www.island.lk/2010/03/15/business1.html>].

¹¹ Daniel, Devan, (undated), "Indo-Lanka FTA is 10 Years Old," *The Island Online*, available: [<http://www.island.lk/2010/03/15/business1.html>].

arrivals and over 50 per cent of tourists from Asia for 2011.¹² Furthermore, this improved connectivity with India through expansion of airline services has led to an increase of 64% of tourist arrivals from India from 2004.¹³

Negotiations under the ISFTA

The ISFTA came into operation on 1st March 2000 following the exchange of letters between the Secretary of Commerce of India and the Secretary of Finance of Sri Lanka. However, the agreement was renegotiated following discussions between the Secretaries of Commerce on 6th June 2002, a Joint Ministerial Committee Meeting on 7th June 2002, and a Senior Officials Meeting on 4th July 2002.

Both sides had made a number of requests that were instated in the agreement following negotiations. These requests revolved primarily around tea, garments, and bulk cement. Sri Lankan authorities had called for more entry ports to deliver their shipments of tea, with the Indian government responding positively and allocating an additional two ports (Mumbai in the West and Vishakhapatnam on the East) in addition to the originally allocated ports of Cochin and Kolkata. Indian authorities, on the other hand, requested permission to export tea to Sri Lanka, specifically for home consumption, with Sri Lanka agreeing to this request upon the conditions that the Indian tea met certain quality standards and India paid its remaining MFN duty.

Sri Lanka submitted several requests regarding garment exports. Sri Lankan authorities had called for an increase in duty tariff concessions on 51 tariff lines from 50% to 75%, to which India agreed¹⁴. Nonetheless, ad valorem duty concessions would remain at 50%. Another request submitted by Sri Lanka was to increase the quota of fabric of non-Indian origin, with India agreeing and subsequently increasing the quota from 2 million pieces per annum to 4 million pieces. India also consented to an increase in quota per garment category from 1.5 million pieces per annum to 2 million pieces per annum. Sri Lankan authorities had also called for more ports to deliver shipments of garments, to which India agreed and provided Kolkata and Mumbai as additional entry points.

¹² Central Bank of Sri Lanka, 2012, *Annual Report 2011*.

¹³ Central Bank of Sri Lanka, 2012, *Annual Report 2011*.

¹⁴ Mukherji, Indra Nath, Tilani Jayawardhana, and Saman Kelegama, 2002, *Indo-Sri Lanka Free Trade Agreement: An Assessment of Potential and Impact*.

Indian authorities had called for an increase in the Margin of Preference (MOP) from 20% to 50% for Sri Lanka's imports of bulk cement from India. Sri Lankan government officials responded to this request by increasing the MOP to 35%.

Despite these developments in negotiations, India initially took a rather cautious approach when negotiating the FTA. Specifically, the primary concern among Indian authorities was that transit trade would unfairly benefit from the zero duty concessions of the FTA. India has stated that any violation of the rules of origin or the 40% local value addition clause on goods exported to India could open up possibilities of transit trade taking advantage of the zero duty concessions¹⁵. The secretary-general of the Federation of Indian Chambers of Commerce and Industry (FICCI) pointed out that Sri Lanka was being used as a trade corridor through which Chinese goods were being imported into India, particularly with copper and electronic components. Another case of trade diversion was China's use of Thailand as a transit point, through which cheap electronics, consumer goods, clothes, and silk were exported to India.

These concerns were reflected in the subsequent negotiations of the South Asian Free Trade Agreement (SAFTA) which included member countries Sri Lanka, India, Pakistan, Nepal, Bangladesh, Bhutan, and the Maldives. When delegates from the member countries met for the first round of negotiations in early March 2004, the primary concerns included developing the rules of origin criteria and agreeing upon tariff liberalization measures, as well as deliberating on the list of the most sensitive products¹⁶.

Following the positive impact of the ILFTA on Sri Lanka's exports to India and overall trade volume, the two governments decided to expand economic cooperation and develop a Comprehensive Economic Partnership Agreement (CEPA). The Joint Study Group (JSG), a committee delegated with examining the costs and benefits of the potential agreement and which included representatives from the public and private sectors in both countries, was formed thereafter and published its report in October 2003. The purposes of the CEPA included expanding on the economic cooperation already established by the ILFTA through further liberalization of trade in goods, as well as liberalization of trade in services and investment¹⁷.

¹⁵ "India's Cautious Approach Slows FTA Negotiations," *Daily Mirror*, 23rd November 2004.

¹⁶ "Road Map Created for SAFTA Negotiations," *Daily Mirror*, 6th March 2004.

¹⁷ de Mel, Deshal, 2009, *The Role of Stakeholders in the Formulation of Inclusive Trade Policies: What Went Wrong with the Indo-Lanka CEPA Negotiations?*, United Nations Economic and Social Commission for the Asia Pacific.

The further liberalization of trade in goods was to take place through eliminating certain items on the negative lists to widen the selection of goods subject to liberalization. An increase in investment in Sri Lanka was expected to take place through the security and predictability that was to be offered to Indian investors through the CEPA. Perhaps most importantly, the opening up of trade in services was expected to take advantage of the rapidly growing demand for services (brought about by rapid economic growth) in India at the time, with the cost of services offered by Sri Lanka being relatively competitive due to the higher wages in India and appreciation of the Indian rupee¹⁸. Considering India's vast and growing middle class, the implementation of the CEPA would have enabled Sri Lankan firms to tap into the country's substantial demand for Sri Lanka's burgeoning services industry. Services such as accounting and book keeping, architecture, computer services, research and development, and travel agency and management consultancy services are already being provided on a small scale to markets in more developed countries. Other sectors such as construction and engineering, financial services (including banking, insurance, leasing, and asset management), and maritime services (including ship building and repair) may also see vast potential in India's markets¹⁹.

Following 13 rounds of negotiations and subsequent to recommendations from the JSG, the CEPA was ready to be signed in July 2008. However, a few weeks prior to this, key details of the negotiations were made public through a seminar and disseminated through extensive media coverage. An immediate and vocal reaction was made by a group of domestic Sri Lankan industrialists, and subsequently picked up by the media and debated by civil society, stating there was a lack of public awareness and highlighting concerns about the Agreement.

The primary concern of the first group, a small number of business people who had faced difficulties in penetrating the Indian market under the ILFTA, was that the problems of the FTA should be dealt with before moving on to signing the CEPA. De Mel (2009), however, argues that with any trade agreement come weaknesses and minor setbacks, particularly in its early stages. The CEPA was not to be seen as a new agreement, but rather as a development of the existing FTA. In fact, many of the problems brought up by the small group of industrialists were addressed during the CEPA negotiations. For example, port restrictions on tea were eased, the rules of origin concerning garment exports from Sri Lanka to India

¹⁸ de Mel, Deshal, 2009, *The Role of Stakeholders in the Formulation of Inclusive Trade Policies: What Went Wrong with the Indo-Lanka CEPA Negotiations?*, United Nations Economic and Social Commission for the Asia Pacific.

¹⁹ de Mel, Deshal, 2009, *The Role of Stakeholders in the Formulation of Inclusive Trade Policies: What Went Wrong with the Indo-Lanka CEPA Negotiations?*, United Nations Economic and Social Commission for the Asia Pacific.

were simplified, and various quotas and restrictions on Sri Lankan exports were removed during the CEPA negotiations. Moreover, the CEPA included a provision which called for bi-annual meetings between trade secretaries to address further issues with the Agreement.

The main concern among civil society was that there was inadequate national level consultation prior to signing the Agreement. Only one month elapsed since the draft schedules of the Agreement were made public and the Agreement was scheduled for signing. As such, there was widespread public perception that the CEPA negotiating process had been rushed, when, in fact, it had taken close to three years. According to de Mel (2009), negotiators did not make it public any earlier because discussions were still going on. Making details of the process available to the public before finalization would have compromised Sri Lanka's negotiating position. However, as suggested by de Mel (2009), the public backlash may have been avoided by disseminating draft schedules of the Agreement after negotiations had been finalized, but with ample time before the Agreement was signed. This may have helped address the public's view that there was a lack of transparency with the whole process. Following this backlash, the Sri Lankan government decided to pull out of negotiations and delay the signing of the Agreement. Since then, the Indo-Lanka CEPA has remained unsigned.

Pakistan-Sri Lanka Free Trade Agreement (PSFTA)

As Pakistan represents Sri Lanka's second largest trading partner in the SAARC region, Sri Lanka was eager to create a free trade agreement with the nation, particularly after the significant market access Sri Lanka received following the FTA signed with India. Accordingly, the PSFTA was signed in 2002 and came into implementation in 2005. The PSFTA takes in to account the asymmetries between the two nations and thus provides each country with a different negative list and time frame for trade liberalization. As stated in article I of the agreement the objectives of the PSFTA are:²⁰

- i. To promote through the expansion of trade in goods and services the harmonious development of the economic relations between Pakistan and Sri Lanka.
- ii. To promote fair conditions for competition for trade in goods and services between Pakistan and Sri Lanka.
- iii. To contribute in this way, by the removal of barriers to trade in goods and services, to the harmonious development and expansion of bilateral as well as world trade.

The duty concessions of the Pakistan-Sri Lanka FTA are given in the table below:

Table 4: Duty Concessions

Duty Concessions	Pakistan's Commitments (number of tariff lines)	Sri Lanka's Commitments (number of tariff lines)
No concessions (Negative List)	540	697
Immediate zero duty concessions	206	102
Tariff rate quotas		
Tea: duty free 10,000 MT	4	
Apparel: 35% MOP million pieces	21	
Basmati: duty free 6,000 MT		1
Potatoes: duty free 1,200 MT		1

²⁰ Department of Commerce, PSFTA, Framework Agreement.

Products entitled to Margin of Preference:		
Betel: 20% MOP	1	
Cosmetics: 50% MOP	11	
Trade Liberalization Program	34, 67, 100 % reduction over 3 years	20, 40, 60, 80, 100 % reduction over 5 years

Source: Table 4, de Mel, Deshal, undated, *India – Sri Lanka, Pakistan – Sri Lanka Bilateral Free Trade Agreements*, Institute of Policy Studies of Sri Lanka. Based on Department of Commerce figures.

Initially Pakistan and Sri Lanka offered only 206 and 102 tariff lines respectively for immediate zero duty. However, Pakistan liberalized the remaining products over a three year period ending June 2008, effectively giving Sri Lanka duty free market access to more than 4500 products. Sri Lanka too liberalized its remaining products, excluding those on the negative list, over a five year period ending November 2010.

The Pakistani negative list which consists of 540 products contains many of Sri Lanka’s main exports to Pakistan including tea, rubber products, certain ceramics, paper products and several textile and garment products. Yet, as a result of PSFTA a range of new Sri Lankan products have penetrated the Pakistani market. These products include fresh pineapple, sports goods, tamarind with seeds, edible oil, porcelain tableware & kitchenware, ceramic tiles, furniture, electrical switches & sockets, herbal cosmetic products, plastic articles, paints, glass paintings, leather products, frozen fish, prawns, lobsters, crabs, cut flowers & foliage, gems & Jewellery and aquarium fish.²¹ The Sri Lankan negative list on the other hand consisting of 697 products contains most of the agriculture sector, rubber, products, paper products, footwear, ceramic products, many motor vehicles & part, along with several metal products.

²¹ *Indo-Sri Lanka Free Trade Agreement (ISFTA)*, Bilateral Affairs, Department of Commerce. [\[http://www.doc.gov.lk/web/index.php?option=com_content&view=article&id=62%3Abilateral-affairs&catid=38%3Aservices&Itemid=75&lang=en\]](http://www.doc.gov.lk/web/index.php?option=com_content&view=article&id=62%3Abilateral-affairs&catid=38%3Aservices&Itemid=75&lang=en)

Impact on Trade

Initially the impact of the PSFTA on the value of Sri Lanka's exports to Pakistan seemed negligible. In 2003 the value of Sri Lankan exports to Pakistan was US\$ 36 million (0.7 percent of total exports). 2007 saw this figure rise to US \$ 56 million, but this figure still accounted only for 0.7 percent of Sri Lanka's total export. Over the same period Pakistan experienced growth in exports to Sri Lanka at a much faster rate, with Sri Lankan imports from Pakistan rising from US\$ 71 million in 2003 (1 percent of total imports), to US\$ 178 million in 2007 (1.6 percent of total imports). Further, the growth in Sri Lankan exports to Pakistan was seen mainly in the same goods exported to Pakistan before the agreement.²²

However, even with both nations liberalizing all products not on the negative list, the expected major increase in Sri Lanka's exports to Pakistan have not been seen. Sri Lanka's exports to Pakistan did rise from US\$ 26 million during the January to May period in 2010, to US\$ 34 million in the corresponding period of 2011, representing a growth of 30.8 %. This rise was mainly due to a significant increase in exports such as natural rubber, vegetable products, desiccated coconut, new pneumatic tires, MDF boards , dried leguminous vegetables, copra, natural graphite, woven fabric etc. Yet, over the same period, exports of certain goods such as oil-cake and other solid residues, sewing thread of man-made staple fibers, tea, nutmeg, pepper, rubber strips, coconut oil and its fractions have actually decreased.²³ Thus, the overall impact of PSFTA on trade has been limited as Pakistan has continued to represent only a minute market for Sri Lankan exports.

²² de Mel, Deshal, undated, *India – Sri Lanka, Pakistan – Sri Lanka Bilateral Free Trade Agreements*, Institute of Policy Studies of Sri Lanka.

²³ *Overview: Pakistan – Sri Lanka Free Trade Agreement (PSFTA)*.

[http://www.doc.gov.lk/web/index.php?option=com_content&view=article&id=114&Itemid=117&lang=en]

Table 5: Exports to Pakistan

Year	Export value to Pakistan (US\$ million)	% of total exports
2006	58	0.8
2007	55	0.7
2008	71	0.9
2009	55	0.8
2010	60	0.7

Source: Department of Commerce, Sri Lanka

As shown in the table above, the value of Sri Lanka's exports to Pakistan did not grow considerably but instead fluctuated over the 2006 to 2010 period, with growth in 2008 and 2010 alternating with lower levels of exports in 2007 and 2009. A most noticeable feature of the above table however, is the value of exports to Pakistan as a percentage of Sri Lanka's total exports. This figure has remained very low throughout the 5 year period and has failed to rise above 1% indicating that Pakistan is not a significant destination for Sri Lankan exports. Consequently, the table further re-iterates the limited impact the PSFTA has had on trade between the two economies.

Impact on Investment

While the FTA would not have a direct impact on the flow of investment between the two economies, looking at the foreign direct investment (FDI) coming from Pakistan over a period of years, we could assess the possibility of the PSFTA indirectly increasing the level of FDI coming to Sri Lanka from Pakistan. In order to do so the table below lists out the level of FDI from Pakistan in 2006, the year immediately following the implementation of the PSFTA, 2009, the year immediately following Pakistan's liberalization of remaining products and 2011, the year immediately following Sri Lanka's liberalization of remaining products.

Table 6: FDI from Pakistan

Year	FDI from Pakistan (US\$ Million)
2006	1.123
2009	0.53
2011	3.078

Source: Board of Investment of Sri Lanka.

While FDI from Pakistan was at US\$ 1.123 million in 2006, three years later in 2009 following Pakistan's liberalization of remaining tariff lines the level of FDI had significantly reduced by 52.8% to US\$ 0.53 million. This indicates the fact that PSFTA did not have a significant impact on the flow of investment from Pakistan to Sri Lanka and that other factors play a more crucial role in influencing the level of investment. 2011 however, saw a remarkable increase in the level of FDI incoming from Pakistan, which had grown by 480% since 2009, to US\$ 3.078 million. Yet, at this juncture we are unable to know how much or if any of this increased FDI can be attributed to the PSFTA.

The major Pakistani investment projects that have commenced in Sri Lanka over the 2006-2011 period are given below along with the project description and the value of the total investment.²⁴

Table 7: Pakistani FDI Projects in Sri Lanka

Project Name	Project Description	Investment Amount (Rs. Million)
Agro Farm Lanka (Pvt) Ltd	Cultivate fruits and vegetables	17.25
Standard Vanguard Services (Pvt) Ltd	Business process outsourcing center	17.10
Z M Kasuals (Pvt) Ltd	Garments	120.00
Z M Vision (Pvt) Ltd	Readymade garments	50.00
Mushtaq Impex (Pvt) Ltd	Potatoes and vegetables	30.00

Source: Board of Investment of Sri Lanka.

²⁴ Board of Investment of Sri Lanka.

Although large scale investment projects such as those mentioned above have commenced over the 2006-2011 period, the value of the investments from Pakistan are significantly lower than that from Sri Lanka's major trading partners such as China and India. This too suggests that the effectiveness of the PSFTA in indirectly encouraging investment is restricted by the fact that Pakistan even after the implementation of the FTA does not represent a major trading partner for Sri Lanka.

An analysis²⁵ of the PSFTA shows that items that with the highest preference that Sri Lanka could export to Pakistan include ceramic goods, fabric, safes, prefabricated buildings, food preparations, and motorcycles. However, as of 2005, Sri Lanka was not exporting any high-preference point goods over \$1 million. The highest-earning high-preference point goods were coconut ekel products (used in brooms and brushes) (valued at \$830,000), vehicle parts (\$40,000), rubber sheets (\$30,000), twine (\$30,000), iron and steel household products (\$30,000), and prefabricated buildings (\$30,000). As of 2005, Sri Lanka exported only 156 products (6-digit HS code) to Pakistan, indicating much potential for expanding the basket of export goods. Out of these goods, there are only eight items that are classified high-preference goods, with more than two-thirds of exports being classified as low-preference. Since many of the goods that Sri Lanka exports to Pakistan have low preference, there may not be a significant expansion in traded volume of exports in the near future, unless Sri Lanka diversifies its basket of goods to higher-preference point items.

Sri Lankan exports receiving duty-free concessions account for 80% of exports to Pakistan. However, these goods account for only 32 items out of the total 156 exported to Pakistan. The major exports include copra, rubber products, tea, coconuts and coconut products, rice, nutmeg, cinnamon, cloves, pepper, and textiles like tarpaulins. The only goods that were in the top 50% of exports in terms of value and that scored high-preference points were coconut ekel products, prefabricated buildings, and food preparations.

²⁵ Yatawara, Ravindra A., 2007, *Exploiting Sri Lanka's Free Trade Agreements with India and Pakistan: An Exporter's Perspective*, South Asia Economic Journal, Sage Publications.

Table 8: Top 5 Exports to Pakistan

2003		2007		2011	
Product	Value (SL Rupees)	Product	Value (SL Rupees)	Product	Value (SL Rupees)
Copra	1.1 billion	Copra	1.2 billion	Rubber sheets	2.1 billion
Fermented black tea	591 million	Rubber sheets	1.1 billion	Vegetable products	708 million
Rubber sheets	571 million	Rubber latex	543 million	Fermented black tea	526 million
Vegetable products	274 million	Vegetable products	498 million	Dessicated coconut	524 million
Natural rubber	232 million	Dessicated coconut	481 million	Rubber latex	517 million

Source: Calculated using data from the Department of Commerce, Sri Lanka

An examination of the top five exports to Pakistan shows little change in the primary products before and after the agreement was implemented in 2005. In both 2003 and 2007, copra was the largest export, as shown above, with negligible difference in export receipts earned. Even after both countries fully liberalized trade, earnings did not see a dramatic increase.

Table 9: Top 5 Imports from Pakistan

2003		2007		2011	
Product	Value (SL Rupees)	Product	Value (SL Rupees)	Product	Value (SL Rupees)
Woven cotton fabric	1.96 billion	Woven cotton fabric	5.2 billion	Wheat grain	4.2 billion
Dried fish	635 million	Potatoes	1.6 billion	Woven cotton fabric	3.5 billion
Potatoes	367 million	Milled rice	1.2 billion	Welded iron or steel tubing	2.3 billion

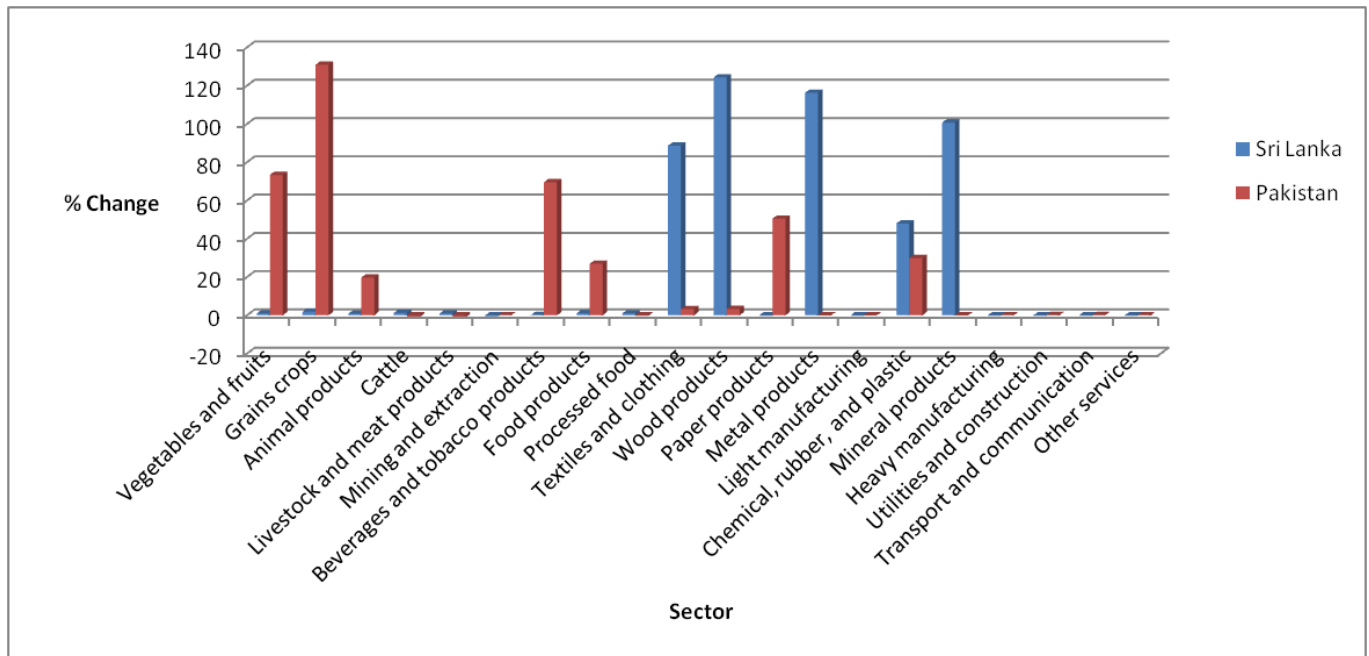
Milled rice	347 million	Welded iron or steel tubing	855 million	Onions	2.1 billion
Medicaments	345 million	Dried fish	723 million	Portland cement	1.9 billion

Source: Calculated using data from the Department of Commerce, Sri Lanka

Sri Lanka’s top five imports from Pakistan indicate that the variety of key imports remained similar throughout the pre- and post-implementation period. Woven cotton fabric stayed among the top two imports between 2003 and 2011. Other products that were heavily imported and stayed among the top five include potatoes and milled rice, both in 2003 and 2007.

Sectoral Analysis of PSFTA

Figure 2: Impact of Full Trade Liberalization on Exports from Sri Lanka and Pakistan, 2010



Source: Ahmed, Saira, Vaqar Ahmed, Irfan Sarfaz, and Safdar A. Sohail, 2010, *Trade Agreements between Developing Countries: A Case Study of Pakistan – Sri Lanka FTA*, IMT Institute for Advanced Studies.

The above graph shows the various sectors on which the PSFTA has had an impact. One can see that, with full trade liberalization, exports for both countries increased dramatically for several sectors. Sri Lankan exports to Pakistan surged in the textiles and clothing industries by 88%, wood products increased by 124%, and metal products increased by 116%. Pakistani exports also experienced substantial increases, with grains crops surging by 131%, vegetables and fruits increasing by 73%, and beverages and tobacco products increasing 70%.

A survey conducted by Ahmed et al. (2010)²⁶ looked at various sectors of the Pakistani economy to gauge the impact of the PSFTA. Exporters and importers in Pakistan were interviewed to obtain information on how effective the PSFTA was perceived to be among the business community.

Importers of Sri Lankan goods in Pakistan were interviewed in the sectors of rubber and plastics, electronic equipment, and chemical products. Those involved in the importing of rubber and plastics reported that imports had increased by an average of 5% following the implementation of the PSFTA. However, they complained that non-registered business operators were also taking part in the importing of Sri Lankan goods. Furthermore, importers were concerned that Sri Lankan exports may soon be diverted to Malaysia, Indonesia, or Vietnam which reportedly have no sales tax on the imports of rubber and plastics, while Pakistan charges a relatively high sales tax.

Importers in the electronic goods sector reported an increase of an average of 5% in the post-FTA period, following implementation in 2005. Importers in this sector in Pakistan are relieved with the decrease in the number of documents required for importing, but are concerned about the remaining complex filing requirements. As such, they have called upon government trade bodies in both countries to simplify existing requirements.

The chemical products sector reported an increase in imports of 15% following the implementation of the PSFTA. However, importers have called for more effective pre and post delivery checks at ports to ensure high quality and improved port storage facilities for chemical products.

²⁶ Ahmed, Saira, Vaqar Ahmed, Irfan Sarfraz, and Safdar A. Sohail, 2010, *Trade Agreements between Developing Countries: A Case Study of Pakistan – Sri Lanka FTA*, IMT Institute for Advanced Studies.

The key complaint among exporters was that they felt the government did not play a strong enough role with regard to spreading awareness of the FTA. Furthermore, exporters complained about the difficulty in obtaining a certificate of origin. Many exporters also stated that the average time taken for each stage in the export process, including acquiring licenses, processing shipping bills, and obtaining customs clearances, was higher than the time taken in competing economies like China and East Asia.

Exporters in the fabric sector reported an increase of only 0.3% of export receipts in the post-FTA period. They insist that there is a need for greater coordination between trade associations in the two countries and also between government trade bodies in the respective countries. Exporters are also concerned about the increasing competitiveness of businesses in China and India and call for greater support from the Pakistani government. Exporters in the spinning and weaving sectors indicated that exports to Sri Lanka had decreased from roughly 7% to 6% after the implementation of the FTA. Several factors have been attributed to this decrease, including Sri Lanka's FTA with India which may have displaced some of the Pakistani exports, in addition to a domestic regulatory requirements regime in Sri Lanka which has been deemed complicated to the point of acting as a non-tariff barrier.²⁷ Sri Lankan government trade bodies have been called upon to increase domestic awareness in Sri Lanka about the benefits of the FTA.

Negotiations under the PSFTA

Sri Lanka and Pakistan signed the PSFTA in Colombo on 1st August 2002, with implementation taking place on 12th June 2005. The two sides agreed to remove all non-tariff barriers on goods and services, halt any increase in existing para tariffs, and prevent any introduction of new para tariffs without the consent of both sides. Following the implementation of the agreement, there has been interest from both countries to expand trade and investment to cover more sectors in agriculture and industry. Taking into account the economic asymmetries that exist between the two countries, the PSFTA accords Sri Lanka with the obligation to offer only 102 items on a duty-free basis, while Pakistan has offered 206 items. Sri Lanka's Negative List consists of 697 items while Pakistan's List consists of 540 items. Unfortunately, there is very little information available about Sri Lanka's negotiating experiences under the PSFTA.

²⁷ Ahmed, Saira, Vaqar Ahmed, Irfan Sarfraz, and Safdar A. Sohail, 2010, *Trade Agreements between Developing Countries: A Case Study of Pakistan – Sri Lanka FTA*, IMT Institute for Advanced Studies.

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