

# *Sri Lankan Integration into Indian Supply Chains under the Bilateral Free Trade Agreement*

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# **Sri Lankan Integration into Indian Supply Chains under the Bilateral Free Trade Agreement**

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## ABSTRACT

Close economic ties and virtual ‘free trade’ between the small island economy of Sri Lanka and its growing big neighbor – India, appear to have created scope for the former to integrate into the supply chains of the latter. The paper is aimed at studying whether Sri Lanka has been integrating into the Indian manufacturing processes in line with emerging trade patterns based on ‘global product sharing’. In spite of popular perceptions about the deeper integration of Sri Lanka into Indian supply chains, the study suggests that Indo-Lanka Free Trade Agreement (FTA) has not led to a breakthrough in the ‘old style’ trade integration between the two countries. While Sri Lanka’s trade expansion under the FTA has brought about peculiar outcomes, the country’s integration to Indian manufacturing processes has performed slowly and continued to remain weak. The specific policy issues related to Indo-Lanka FTA itself and to the bilateral trade expansion appear to have hindered their product-sharing. Generally, trade and growth patterns in both Sri Lanka and India are different from the experience of East and Southeast Asian countries which created opportunities to accommodate the formation of globalized supply chains of fragmented manufacturing processes. The study draws out conclusions and inferences with policy relevance for bilateral trade, while notifying the danger of bilateral ‘free trade’ against rising protectionism.

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## 1. INTRODUCTION

There is a popular perception about the greater potentials for manufacturers in Sri Lanka, including the multinational corporations investing in the country, to enter successfully into Indian supply chains. Given the phenomenal factors underlying Indo-Lanka economic relations, it is plausible to anticipate the existence of an immense opportunity for firms located in Sri Lanka to find competitive niches in the production processes in India more than anywhere else. Between Sri Lanka and India it is virtually ‘free trade’ now, as tariffs have been gradually phased out under the Indo-Lanka Free Trade Agreement (FTA) that came into effect in 2000. Over 85 percent of Sri Lankan products exported to India (88 percent of the total export value), and over 90 percent of products imported to Sri Lanka from India (56 percent of the total import value) are covered by the Indo-Lanka FTA in 2010.<sup>1</sup> Indian investment in Sri Lanka has also grown rapidly following the FTA because Indian manufacturers were seeking the benefits of the FTA by producing in Sri Lanka and exporting to India the products that were previously either produced in India or imported from somewhere else.

While Sri Lanka was one of the few developing countries to embark upon trade liberalization as early as in 1977, much later India also followed the suit since early 1990s along with other South Asian countries. Subsequently, India elevated to be a major trading partner of Sri Lanka. Bilateral economic relations have moved beyond merchandise trade as India became a major source market for Sri Lanka’s travel and tourism, aviation, port services, and trade in many other service sectors. The geographical proximity and the colossal size of the growing Indian market are additional factors for the advantage of Sri Lanka strengthening its integration with India.

Integration of individual countries into globalized supply chains has been a growing facet of emerging trade patterns – a phenomenon that has been clearly observed in trade expansion in emerging economies such as those in the East and Southeast Asian region (Athukorala 2011, Athukorala and Menon 2010, Ferrarini 2011, Kimura 2006, WTO 2011). Given the favorable

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<sup>1</sup> Sri Lanka’s exports to and imports from India *within* the FTA and *outside* the FTA (i.e. Sensitive List) were separated using trade statistics reported under 6 – 8 digit HS codes by the Sri Lanka Customs.

conditions for greater economic integration and ‘free trade’ between Sri Lanka and India, it is a valid question to raise whether Sri Lanka is successfully integrating into supply chains located in India, and whether India is expanding the scope for such an integration.

The objective of this paper is to assess and analyze Sri Lanka’s integration into Indian manufacturing processes as an important element of the country’s export-oriented growth process, and to draw conclusions and inferences with policy relevance. Sri Lanka’s regional trade within South Asia in general and bilateral trade with India in particular has been a source of topical interest in trade literature (Abeyratne 2012, Abeyratne and Ranasinghe 2004, Behera and Mukherji 2011, Kelegama 2009, Kelegama and Mukherji 2007). However, an important aspect yet missing in the body of related literature is Sri Lanka’s integration into global supply chains in India and in the South Asian region. The paper is aimed at redressing this gap by investigating Sri Lanka’s integration into Indian supply chains, and opening up new insights into bilateral trade policy issues.

The rest of the paper is organized as follows: Section 2 provides a brief literature survey of the emerging pattern of “global product sharing” particularly in the East and Southeast Asian countries. Section 3 provides an overview of the expansion of Sri Lanka’s bilateral trade with India in the context of their regional and bilateral agreements. Sri Lankan integration into Indian manufacturing processes is examined in Section 4 with an analysis on relevant policy issues. Section 5 presents conclusions and inferences of the study.

## 2. GLOBAL PRODUCT SHARING AND THE RISE OF ‘FACTORY ASIA’

The emerging trade pattern in the world during the past three decades has been different from ‘old-style’ trade patterns. It is no longer the type of exchange between “wine and cloth” as in traditional trade models of comparative advantage. It is neither the exchange of “wine for wine” or “cloth for cloth” as in intra-industry trade models. A new facet of growing trade patterns is the “global product sharing”, led by the production and export of parts and components by different countries, followed by assembly and export of the final good by another country.

The slicing up of the value chain of a commodity into finer parts and components, and international outsourcing of their production and supply have been made possible by the liberalization policy reforms, technological changes in production processes, and the decline in transport costs – all that allowed fragmentation of production across different countries and the formation of global supply chains. The countries that have been integrating into global supply chains are specialized in “performing tasks” instead of “producing goods” (WTO 2011). The process has led individual countries to gain from trade in tasks according to a different form of comparative advantage.

The global product sharing has started in the labor-intensive light manufacturing industries such as electronics and clothing, and has spread into other high-tech and capital-intensive industries. The fragmented production activities which scattered across East and Southeast Asian region, as Ferrarini (2011) points out, have brought together advanced economies such as Japan and Korea to provide high value-added parts and components, middle-income countries such as Malaysia and Philippines to undertake further processing of parts and components, and labor-abundant emerging economies such as China to carry out final assembly. Consequently, the rapid growth of network trade and the rising shares of parts and components in total exports have been an outstanding feature of the export-oriented growth process in East and Southeast Asia. While trade in parts and components and assembled products has generally grown faster than total world trade in manufacturing, East Asia’s dependence on this new form of trade pattern is proportionately larger than elsewhere in the world (Athukorala 2011:65).

As studies have confirmed, East and Southeast Asian countries have generally been increasing the share of parts and components in their total exports and imports, while China alone is playing a crucial role as a major importer of parts and components and as a major supplier of final assembly products for exports. In fact, China is playing even bigger role in its own region; the share of parts and components in China’s manufactured imports from East Asian countries alone accounted for 47 percent of total, and those of exports to East Asian countries 27 percent of total in 2007 (Athukorala 2011:81). Apparently, South Asia and, for that matter India too as the

largest economy in the South Asian region have not performed in line with fast-growing network trade pattern, as compared to East and Southeast Asia.

The rapid expansion in fragmented production processes scattered across the countries has undermined the validity of the old concept of value-added production and exports. Domestic value addition was perceived as an important feature of successful industrialization so that interventionist policies in both import-substitution and export-oriented regimes were sometimes directed at promoting value addition in production and exports. The experience of East and Southeast Asia alone with their growing network trade suggests that *volume* of exports matters more than the *unit value* of exports. The growth of network trade also means that countries would grow fast as a group in a network rather than individuals in isolation, while some of the countries would lead the pack playing a major role in the network.

### 3. SRI LANKA'S BILATERAL TRADE WITH INDIA

Bilateral trade performance between India and Sri Lanka over the past few decades was conditioned by unilateral trade liberalization policies in both countries, and their regional and bilateral agreements. While the policy reforms towards a liberalized trade regime have paved the way for trade expansion in South Asia, there were attempts for greater cooperation and integration in the region since the inception of the South Asian Association for Regional Cooperation (SAARC) in 1985. This was followed by the implementation of two important regional agreements by the SAARC countries – the South Asian Preferential Trading Agreement (SAPTA) in 1995 and, the South Asian Free Trade Area (SAFTA) in 2005. While the goal of achieving a “free trade area” within the South Asian region under the SAFTA continued to remain an unfinished agenda, trade expansion within the region continued to show dismal performance (Ahmed et. al. 2010, Soz and Srivastava 2010). In the midst of the slow progress of regional agreements, SAARC countries have stepped into bilateral FTAs with one another in general and, with India in particular. As India continued to hold a dominant position in regional trade, it was also playing the leading role in trade performance and integration within South Asia.

### *Bilateral versus Regional Agreements*

While Sri Lanka continued to remain a member of the regional agreements in South Asia, it entered with India into a bilateral FTA which was made effective immediately after signing it in 2000. The Indo-Lanka FTA surpassed the regional trade agreement (SAFTA) in terms of deeper free trade, larger coverage of trade, shorter time span of progress, and the thinner rules of origin (Table 1). This means that Sri Lanka's bilateral trade with India has been performing under the Indo-Lanka FTA which in effect made the regional agreement SAFTA redundant. Bilateral 'free trade' under the Indo-Lanka FTA was effective since 2008 when Sri Lanka completed phasing out tariffs, while India had already completed it in 2003.<sup>2</sup> In fact, India's time duration required slashing out tariffs was quicker, and its "sensitive list" of products subject to normal tariffs was shorter than those offered by Sri Lanka. Although this was perceived as a generous offer on the part of India, from the Sri Lankan point of view the trade benefits of "delayed performance" remain to be assessed.

Given the unilateral policy reforms and the bilateral FTA, the groundwork has been set fourth for greater economic cooperation and integration between Sri Lanka and India. It appears that the shares of both exports to and imports from India, as percentages of totals, have recorded a massive increase immediately after the implementation of the FTA (Figure 1). One notable change is the elevation of India as the top source market for Sri Lanka's imports, and one of the top destination markets for its exports. According to trade statistics from the Central Bank of Sri Lanka (CBSL) in 2010, USA and UK – Sri Lanka's first and second largest export markets together accounted for one-third of total exports, while India being the third largest export market accommodated six percent; being the largest source market for Sri Lanka's imports, India supplied 19 percent of total imports, followed by Singapore – the second largest supplier accounting for 12 percent.

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<sup>2</sup> Sri Lanka also entered into a bilateral FTA with Pakistan in 2005 under which the period of tariff phasing out has been completed in 2010 (Abeyratne 2012). Sri Lanka's bilateral integration is expected to move beyond merchandise trade through the proposed comprehensive economic partnership agreement (CEPA) with India in 2003 and, another with Pakistan in 2008. These agreements envisaged extending the bilateral economic integration under all 4 Modes of trade in services. However, the signing of the agreements delayed so far due to pressure from lobbying groups in the respective countries.

The importance of Sri Lanka's traditional export destinations – USA, UK, and EU, has declined with a rapid growth of exports to India since 2000. In the case of imports too, it appears that Sri Lanka has shifted away from its traditional source markets – from the Western countries, first to the East and Southeast Asian countries in the 1980s, and then to India since the mid-1990s. Sri Lanka's trade within the South Asian region is explained largely by trade with India which accounts for about 90 percent of the country's regional trade. Sri Lanka's FTA with Pakistan has so far produced only a marginal impact on bilateral trade between the two countries, and has not been able to alter the dominant Indo-Lanka trade share of regional trade (Abeyratne 2012). Whether it is due to the FTA or not, interestingly, it is with India that Sri Lanka observed its most dynamic changes in bilateral trade during the past decade.

#### *Bilateral Trade with India: More Questions than Answers*

Sri Lanka's bilateral trade with India *before* and *after* entering into the FTA as well as *within* and *outside* the FTA has, however, revealed peculiar characteristics leading to more questions than answers. Generally, exports and imports covered by the 'sensitive lists' appear to have grown faster than those covered by the Indo-Lanka FTA during 2001-2010, the first 10-year period of the implementation of the FTA (Table 2). According to the compound annual growth rate, exports covered by the FTA have recorded an impressive expansion by 62.7 percent during the first 5-year period (2001-2005), which have recorded a contraction by 4.7 percent during the second 5-year period (2006-2010). In contrast, the growth of other exports covered by the 'sensitive list' has accelerated from 18.9 percent during 2001-2005 to 33.4 percent during 2006-2010.

Although international trade in the world was generally disrupted in the second half the decade due to world economic downturn, the paradoxical outcome in bilateral trade between Sri Lanka and India is primarily a result of *ad hoc* policy changes altering the conditions stipulated by the FTA. More than half of Sri Lanka's exports covered by the FTA in 2005 were represented two commodities – fats and oils, and copper and copper products. Industries to produce these commodities flourished in Sri Lanka mainly through investment from India to receive the benefit



of tariff concessions of the Indo-Lanka FTA. India's unilateral decision to alter the protective measures in 2006 has resulted in a collapse of these two industries in Sri Lanka, resulting in a decline of their trade share to less than 6 percent by 2010.

The rapid growth of some of the exports to India as well as the contemporary increase in FDI inflows from India to Sri Lanka were responses to the FTA which allowed free access for exports from Sri Lanka to the Indian market, protected from imports from the rest of the world. It was clear that a bulk of exports which grew under the FTA were 'too sensitive' to the incentive structure of the agreement showing their 'footloose' nature of establishment. In contrast, those exports covered by the 'sensitive list' of the agreement were showing a steady growth outside the FTA even if they were subject to the normal tariffs.

In spite of Sri Lanka's lengthy 'sensitive list', imports covered by that have grown annually by 18.4 percent, compared to the growth of imports covered by the Indo-Lanka FTA during 2001-2010. The rapid growth of imports covered by the sensitive list was also contributed by petroleum imports of which the world prices rose remarkably during this period. In spite of that, Sri Lanka has been diverting its import trade from the rest of the world towards India in the past two decades due to cost differences. Presumably, India's trade liberalization process in the 1990s would have been instrumental in its export expansion.

As Sri Lanka also imports a bulk of machinery, intermediate goods and raw materials from India, the particular pattern of production specialization and export expansion in Sri Lanka could be an underlying factor of the growing imports from India. In that respect, it is reasonable to assume that Sri Lanka would have missed some of the long-term benefits that it would have otherwise reaped due to the maintenance of a lengthy sensitive list. Moreover, it is clear that even in the absence of the FTA, the increase in Sri Lanka's imports from India would not have been significantly different from the growth of imports under the FTA.

#### 4. SRI LANKAN INTEGRATION INTO INDIAN MANUFACTURING PROCESSES

As the export mix of a country comprises raw materials, parts and components, and final goods (both consumption and capital goods), the integration of Sri Lankan industries into manufacturing processes in India could be identified by decomposing the export mix into different categories. By using the trade statistics reported in Sri Lankan data sources as well as in Indian data sources under HS coding are used in this analysis.<sup>3</sup> According to the HS coding, parts and components of manufactured products can be identified from the HS Section 07 (Chapter 39-40) and onwards. All commodities classified under HS Sections 01-06 (agriculture, food, mineral and chemical) could be categorized as finished products or raw materials, although these two categories are not limited to the sections specified. The category of raw materials – substances that transform into different commodities in the production process, can be extended to cover a wide range of sections up to HS Section 15. By separating raw materials, and parts and components from India's imports from Sri Lanka (or inversely, Sri Lanka's exports to India), it is possible to portray Sri Lanka's integration into the Indian production processes.

#### *Supply of Parts and Components versus Raw Materials*

A higher level of integration into a country's supply chain should be depicted by a greater share of imported parts and components embodied in the production process. India's imports from Sri Lanka has expanded significantly from a low base of USD 45 million in 2000/01 to USD 578 million in 2010/11 (Table 3). In 2000/01, out of India's total imports from Sri Lanka 54.8 percent comprised finished goods, and 40.5 percent raw materials. With an increase in the share of finished goods, and a decline in that of raw materials, however, even after 10 years the presence of finished goods and raw materials in India's imports from Sri Lanka is overwhelming, amounting to 72.7 percent and 20.5 percent of total respectively. This leaves only a little space for Sri Lanka's integration into Indian production processes through the supply of parts and components, which accounts for 6.9 percent of India's total imports. The increase in the share of capital goods reaching 18.2 percent of total is a notable change, which appears to have been

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<sup>3</sup> Methodology of measuring global product sharing has evolved basically in two branches . One is based on the use of trade statistics from individual countries recorded under either Standard International Trade Classification (SITC) system or Harmonized System (HS) coding (for instance, see Athukorala 2011, Athukorala and Menon 2010, Ferrarini 2011, Kimura 2006). The other is based on Input-Output Tables to measure the domestic and foreign sources of valued added in production activities (for instance see, Hummels et. al. 2001, WTO 2011).

contributed largely by a single industry – ship building, which has shared nearly 80 percent of capital goods exports to India in 2010/11.<sup>4</sup> This means that the supply of other capital goods also shows a thin dispersion across the sectors under HS codes 84 and onwards.

Over the period 2000/01 – 2010/11, Sri Lanka has increased its manufactured exports to India, and diversified the export structure (Table 4). While the extent of the importance of these changes remains a source of questions and debates, the weak improvement in the supply of parts and components is a less-disputable issue. The most important industries that supply more than half of parts and components are Plastics, rubber and articles thereof (HS 39-40), Base metals and articles (HS 72-83), and Machinery and parts thereof (HS 84-85). A closer look at the presence of parts and components in India's imports from Sri Lanka further reveals the weakness rather than the strength of the Sri Lankan export sector in integrating into the Indian supply chains. Parts and components appear to have concentrated largely in two commodity categories: as usually the case, Machinery and mechanical appliances (HS 84) that account for 41.5 percent of total parts and components and, a narrowly defined category of tires and tubes (HS 40) that account for 32.9 percent of total parts and components (Table 5). However, more than half of parts and components within Machinery and mechanical appliances come from a single commodity – Aircraft engines.

The cross-border supply of raw materials into manufacturing activities is, however, a primitive form of entering into the Indian production processes that Sri Lanka has continued to do for decades. Raw materials that India traditionally imported from Sri Lanka included the products of the country's resource-based industries such as rubber and minerals, as well as raw materials in the form of waste and scrap paper, waste and scrap metals, and raw materials for textile industry. Trade expansion during the period under the FTA has, in fact, led to a further improvement and a diversification of the supply of raw materials into the Indian manufacturing industries.

### *Bilateral Free-Trade and 'Old Style' Integration*

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<sup>4</sup> This was also contributed largely by the export consignments of a single shipbuilding company – Colombo Dockyard PLC, which succeeded in receiving supply contracts from India.

The supply of parts and components from Sri Lanka to Indian production processes accounts for small share and, has grown slowly as a share of total Indian imports from Sri Lanka. In contrast, the primitive form of integration through the supply of raw materials is still dominant, though its share in total imports of India has declined. This means that, in spite of the most-free bilateral tariff regime that has been established under the Indo-Lanka FTA, the Sri Lankan integration appears to be weak, and Sri Lanka is yet to emerge as an established source market for Indian supply chains. This finding is quite different from the growing pattern of global product sharing in East and Southeast countries, and is contradictory to the popular perceptions in the context of bilateral free trade between India and Sri Lanka.

While the puzzle needs to be resolved by looking at both the supply-side factors in Sri Lanka and the demand-side factors in India, the discussion encompasses a wide range of specific and general issues of trade and development. Specific issues are related to bilateral trade expansion between India and Sri Lanka, and to the operational aspect of the Indo-Lanka FTA. The general issues encompass the level of development and the trade policy issues in a wider perspective.

The existence of non-tariff barriers (NTBs) has continued to remain a source of topical interest in policy discussions and research analyses on Indo-Lanka FTA (Ahmed et. al. 2010, Behera and Mukherji 2011, Kelegama and Mukherji 2007). In addition to the para-tariffs and domestic taxes, a wide range of NTBs in the form of quantitative restrictions (QRs), rules and regulations, and the 'weaknesses' emerging from trade administration itself appears to hamper potential bilateral trade expansion. The theoretical and technical underpinnings of the FTA naturally overlooked trade obstacles emanating from a complex set of NTBs. Besides, the FTA itself has brought about NTBs in the form of 'rules of origin' of traded goods, clearly contradicting the emerging patterns of network trading. Further, the *ad hoc* revisions in tariffs, para-tariffs, domestic taxes, and NTBs affecting trade under the FTA have added elements of risks and uncertainties to Indo-Lanka bilateral trade.

What would be the comparative advantage for India to allow product fragmentation and outsource the supply of parts and components to countries like Sri Lanka? In other words, what would be the niche areas of competence for Sri Lanka to enter into the manufacturing processes

in India? This is a valid question to answer because virtually India would appear as a large country with abundant labor and diverse resources to consolidate vertical integration within India itself. The experience of East and Southeast countries in general, and that of large countries like China in particular, provided with ample examples to reject a hypothesis as such. As was already discussed, China as a large labor abundant country in the East Asian region (like India in the South Asian region) is growing fast as an emerging center of the region for network production, integrating other countries in the region into network trade. It is also hosting large inflow of FDI that seeks better locations mostly for final assembly activity of global product sharing. Even though network trade is slowly emerging in India, as at present it is difficult to identify India as a center of global product sharing and network trade in the South Asian region. In a comparative perspective, it is possible to identify that the development stage and trade pattern of India and in the South Asian region is significantly different from what is observed in East and Southeast Asian countries.

#### *Policy Constraints at Both Ends*

A comparative perspective on the issue reveals that unlike China or other East and Southeast Asian countries, India does not have 'globalized' supply chains in order to permit Sri Lanka or any other country to get integrated. In spite of its trade liberalization process over the past two decades, India's manufacturing growth has made little changes to its production processes of which the vertical integration is mostly confined to the large domestic economy. Out of total imports of India which amount nearly to USD 370 billion in 2010/11 the share of parts and components accounts for 6 percent only (Table 6). Interestingly, the share of raw materials is as high as 45.7 percent of total imports. According to Athukorala (2011: 75), South Asia and India record a significantly *lower* share of network products in manufacturing exports and imports in 2006-07, compared to its average of developing countries as well as to that of China, East Asia and ASEAN countries, although there has been a slow pace of increase in that share since early 1990s. The evidence suggests that the production processes of India as well as those of South Asia in general have not expanded enough in line with the emerging patterns of fragmentation and global sharing of the supply chains, as in East and Southeast Asian countries.

In spite of the progressive achievement of bilateral ‘free-trade’ under the Indo-Lanka FTA, export growth of Sri Lanka during this period since early 2000s reported dismal performance. According to the official statistics published by the Central Bank of Sri Lanka (CBSL), merchandise exports as a percentage of GDP has declined from over 33 percent in 2000 to 17 percent in 2010, while the decline has been sharp and steady during the second half of the decade. Although the global economic downturn has made its contribution to the decline in exports, the domestic policy changes seem to have played the major role. In a new policy regime initiated after 2004, trade liberalization came to a standstill and protectionism revisited, while ‘domestic economic activities’ received policy priority over export promotion (Abeyratne 2010, Athukorala 2012). The new policy regime also received a strong justification against the subsequent world economic turmoil, resulting from food and fuel price hikes in the world, followed by global financial crisis.

FDI inflows play a major role in establishing globalized supply chains as the case in respect of emerging global product sharing in East and Southeast Asian countries. Annual FDI inflows in Sri Lanka continued to remain small and sluggish; according to data from the Board of Investment in Sri Lanka, total value of FDI inflows over the past decade (2001-2010) amounted to only USD 4.3 billion, and it was much less than the annual FDI inflows of many East and Southeast Asian countries. Although dismal performance in FDI inflows was often attributed to the country’s separatist war, its ending with a military victory in May 2009 did not bring about a noticeable change. This outcome not only undermined the validity of above attribution, but also signified the weaknesses in the policy and business environment of the country.

Sri Lanka has provided with a new experimental ground for a case study of the danger of an establishment of bilateral ‘free trade’ in the backdrop of rising protectionism. When Sri Lanka was advancing with a new protectionist regime during the period after 2005 (Athukorala 2012, Pursell 2011), the Indo-Lanka FTA was in progress phasing out tariffs and achieving bilateral ‘free trade’. A bilateral FTA in the context of a protectionist environment gives an uncompetitive advantage for the trading partner of the bilateral agreement which would result in an increase in distorted production and trading patterns nullifying the ultimate benefits of free trade. In fact, the

higher the protection against the rest of the world, the greater would be the distortions emanating from a bilateral FTA.

## 5. CONCLUSION

The preceding analysis led to oust popular perceptions about Sri Lanka's deeper integration into Indian manufacturing processes through bilateral 'free trade' established under the Indo-Lanka FTA. Given a number of phenomenal reasons underlying bilateral economic relations between the two countries and India's economic expansion followed by its policy reforms, the existence of vast potential for such integration could not be denied. In spite of that, the supply of "parts and components" from Sri Lanka to India reflects dismal performance and weak integration with Indian manufacturing processes.

Global product sharing – trade in parts and components, and in assembled products, is a growing facet of world trade, and is a dominant feature of the trading patterns in East and Southeast Asia. While the emerging bilateral trade through Indo-Lanka FTA has reflected peculiar performance, it has not led to a breakthrough in 'old style' bilateral trade between Sri Lanka and India.

The analysis leads to a number of specific and general policy issues which are relevant to both India and Sri Lanka. First, the scope for product sharing is constrained by the FTA itself and the manner in which the FTA was in operation with *ad hoc* policy changes. Although it is virtually 'free trade' between the two countries achieved through merely 'zero tariffs' under the FTA, secondly the existence of numerous NTBs in the form of para-tariffs and domestic taxes, rules and regulations, and the weaknesses emerging from trade administration. Thirdly, the Indian manufacturing processes have also not become as 'fragmented and globalized' as those observed in China and other East and Southeast Asian countries in order to allow Sri Lanka to enter through the FTA into the Indian supply chains. Finally, the analysis also points to the detrimental co-existence of protectionist policy regime and bilateral 'free trade' that could annul the genuine benefits of trade liberalization.

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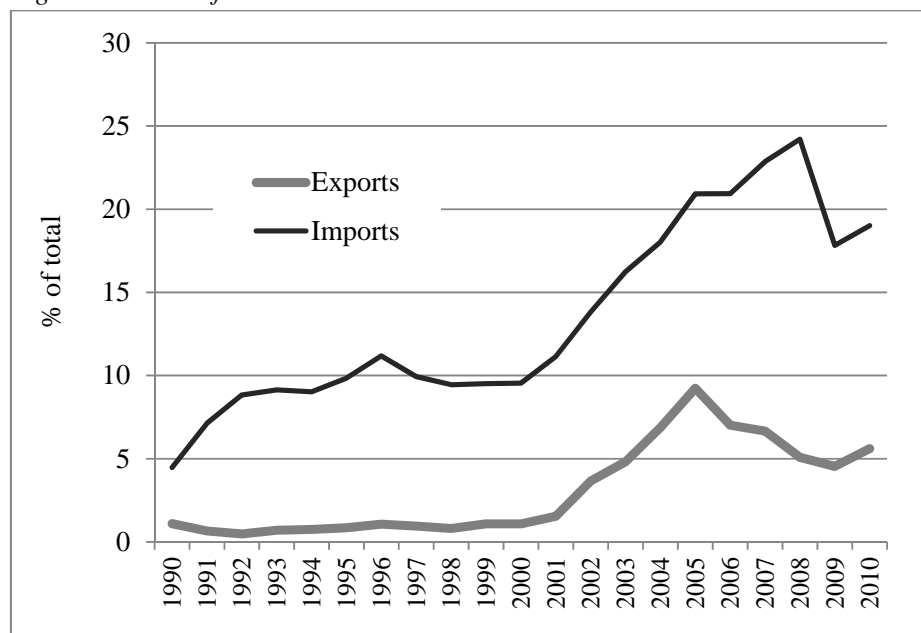
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Table 1: Indo-Lanka FTA and Agreement on SAFTA: Summary

	Sri Lanka	India
<i>Indo-Lanka FTA (2000)</i>		
<i>Tariff reduction</i>	Zero tariffs for 319 items, with immediate effect Tariff phasing out in 8 years (2008)	Zero tariffs for 1351 items, with immediate effect Tariff phasing out in 3 years (2003)
<i>Sensitive list</i>	1220 items	431 items
<i>Rules of origin</i>	Minimum domestic value addition, 35% of fob value	
	In case part of the inputs originates from a contracting country, minimum aggregate content 35%, with minimum 25% domestic input content	
<i>Agreement on SAFTA (2005)</i>		
<i>Tariff reduction</i>	Maximum 20% in 2 years (2008)	Maximum 20% in 2 years (2008)
	0-5% in next 6 years (2014)	0-5% in 5 years (2013)
<i>Sensitive list</i>	1042 items	480 items
<i>Rules of origin</i>	Minimum domestic value addition, 35% of fob value	Minimum domestic value addition, 40% of fob value
	In case part of the inputs originates from a contracting country, minimum aggregate content 50%, with minimum 20% domestic input content	

Source: for the agreement on SAFTA, SAARC Secretariat, web site: [www.saarc-sec.org](http://www.saarc-sec.org); for Indo-Lanka FTA, Department of Commerce, Government of Sri Lanka, web site: [www.doc.gov.lk](http://www.doc.gov.lk)

Figure 1: Share of Sri Lanka's Bilateral Trade with India 1990-2010



Source: CBSL data

*Table 2: Sri Lanka's Bilateral Trade with India, Values and Compound Annual Growth Rates (CAGR) for Selected Years*

	Value (USD million)				CAGR (%)			
	1995	2000	2005	2010	1996-2000	2001-2005	2006-2010	2001-2010
Exports, covered by the FTA	24.4	47.0	536.9	423.2	14.0	62.7	-4.7	24.6
Exports, covered by the Sensitive List	5.5	5.6	13.4	56.6	0.6	18.9	33.4	26.0
Total exports	29.9	52.7	550.3	479.8	12.0	59.9	-2.7	24.7
Imports, covered by the FTA	285.5	365.4	780.1	1417.9	5.1	16.4	12.7	14.5
Imports, covered by the Sensitive List	159.4	202.7	597.2	1099.5	4.9	24.1	13.0	18.4
Total imports	444.9	568.1	1377.2	2517.4	5.0	19.4	12.8	16.1

Source: Sri Lanka Customs data

*Table 3: India's Imports from Sri Lanka, 2000/01 and 2010/11*

	2000/01		2010/11	
	USD million	%	USD million	%
Raw materials	18.2	40.5	102.7	20.5
Parts and components	2.1	4.6	34.4	6.9
Finished goods	24.7	54.8	364.5	72.7
(of which) Capital goods	1.1	2.4	91.3	18.2
Total	45.0	100	501.7	100

Source: Department of Commerce, India, Web site: <http://commerce.nic.in/>

Table 4: India's Imports of Raw materials, and Parts and components from Sri Lanka 2000/01 and 2010/11

HS code	Industry	2000/01			2010/11		
		% of industry totals		USD million	% of industry totals		USD million
		Raw materials	Parts and components	All imports	Raw materials	Parts and components	All imports
25-27	Mineral products	100.0	-	5.3	100.0	-	3.6
28-38	Products of the chemical or allied industries	62.7	-	0.5	91.3	-	10.2
39-40	Plastics, rubber and articles thereof	14.8	5.9	2.7	54.9	21.6	52.6
41-43	Leather and leather products	100.0	-	0.1	44.7	-	0.4
44-46	Wood and articles of wood	-	-	0.2	99.7	0.1	13.7
47-49	Pulp, waste and scrap of paper	56.0	-	4.2	74.4	-	26.9
50-63	Textiles and textile articles	94.9	0.8	2.5	59.4	0.1	34.8
64-67	Footwear, headgear, umbrellas, other	-	14.3	0.1	-	-	0.8
68-70	Articles of stone, plaster, cement etc.	-	8.1	0.4	0.6	0.1	18.6
71	Precious stones, pearls and metal	-	-	0.0	86.2	-	2.8
72-83	Base metals and articles of base metal	92.4	0.6	7.9	10.3	10.3	37.1
84-85	Machinery and parts thereof	-	54.5	2.8	-	21.0	70.7
86-89	Vehicles, vessels and transport equipment	-	28.6	0.1	-	3.7	75.6
90-92	Optical, photographic, etc. equipment and parts	-	42.5	0.4	-	25.6	1.3
93-99	Miscellaneous and other manufactures	-	14.3	0.5	-	8.8	14.3

Note: While zero values refer to less than USD 0.05 million, hyphen mark (-) refers to non-existing transactions.

Source: Department of Commerce, India, Web site: <http://commerce.nic.in/>

Table 5: India's Imports of Parts and Components from Sri Lanka 2010/11

HS code	Products	USD million	% of total
40	Tires and tubes	11.3	32.9
73	Articles of iron and steel	1.2	3.5
76	Aluminum and articles thereof	0.5	1.5
82	Tools of base metal	1.1	3.2
84	Machinery and mechanical appliances	14.3	41.5
840710	(of which): Air-craft engines	8.5	24.6
85	Electrical machinery and equipment	0.6	1.7

Source: Department of Commerce, India, Web site: <http://commerce.nic.in/>

*Table 6: India's Total Imports 2010/11*

	Value (USD billion)	Share (% of total)
Raw materials	169.1	45.7
Parts and components	22.3	6.0
(of which) Machinery, vehicles, and transport equipment	16.2	4.4
Vehicles, vessels, and transport equipment	4.5	1.2
Finished goods	178.4	48.3
(of which) Capital goods	28.1	7.6
Total Imports	369.8	100.0

Source: Department of Commerce, India, Web site: <http://commerce.nic.in/>