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Pathfinder Economic Alert

Sri Lanka's Propitious Future: The Role of the Indo-Lanka Economic Partnership.

Sri Lanka's Transformative Opportunities

The Foreign Minister's visit to India offers an opportunity to reflect on the role of the Indo-Lanka economic partnership in charting the future prosperity of the country. The Pathfinder Foundation (PF) has previously advocated a 'resetting' of the Indo-Lanka relationship and it has emphasized that it should be one of 'irreversible excellence'(article titled ' Resetting Indo – Lanka Relations – Irreversible Excellence is the Goal 200414').

Sri Lanka's current historical conjuncture offers the prospects of achieving unprecedented prosperity. The challenge is to translate hope into optimism and potential into progress. The trajectory of Indo- Lanka bilateral economic relations will be an important determinant of this island nation's future prospects.

Sri Lanka enjoys the most propitious set of circumstances for over 50 years. The end of the 25 -year civil conflict; very favourable economic geography, with Sri Lanka being located in the dynamic Asian region and in close proximity to the large and growing Indian domestic market; excellent relations with China; and the absence of major drags on the country's economic prospects, such as the secular terms of trade decline, demographic pressure and the dirigiste policies that characterized the 1960's and 70's, all combine to provide Sri Lanka with an unprecedented opportunity to shift to a much higher level of growth and development.

Indo – Lanka Relations: The Landscape

The path of Indo-Lanka bilateral economic relations will have a significant impact on Sri Lanka's ability to realize the full potential of the current favourable set of circumstances. However, the debate on the merits of stronger economic links with India, from a Sri Lankan perspective, tends to divide the protagonists on the basis of whether its large neighbor is seen as an 'opportunity' or a 'threat'. The antipathy of those, who belong to the latter category, is often based on primordial fears and insecurities which are not evidence-based or rational in today's context. However, there is also somewhat more considered opposition based on concerns that closer bilateral economic relations would inevitably result in: the asymmetry between the two economies leading to a loss of output (growth) and employment in Sri Lanka; and greater Indian intrusion into the domestic affairs of Sri Lanka leading to an erosion of sovereignty.

In this connection, it is important to highlight the re-setting that has taken place in India's relations with its neighbours (Pakistan continues to be a special case). As a rising global player, it is in India's interest not to be distracted by irritants within the neighbourhood which constrain its wider ambitions. This has been reflected in the bipartisan approach to policies towards neighbouring countries, including Sri Lanka. Progress is already being made in strengthening India's economic relations with Bangladesh, Bhutan and Nepal, particularly in the areas of transport and power connectivity. India has taken a number of unilateral measures to assist neighbouring countries. These include duty and quota-free trade access for SAARC Least Developed Countries and the Reserve Bank of India earmarking $2 billion of its reserves as a safety net for SAARC countries in case they require urgent balance of payments support. Indian businesses have also been encouraged to increase trade and investment with neighbouring countries, including Sri Lanka. The Central Bank of Sri Lanka has also signed a bilateral swap arrangement with the Reserve Bank of India. In addition, a number of Indian business delegations have visited this country recently.

Coping with Asymmetry

The argument that the asymmetry in size between the two economies would preclude mutually beneficial strengthening of bilateral economic relations ignores important considerations. It is important to recognize that India's economic relations with Sri Lanka are based on the principles of non-reciprocity and special and differential treatment. It needs to be highlighted that these principles were at the heart of efforts to negotiate a comprehensive economic partnership agreement between the two countries. Both parties need to be more transparent about the details of any proposed agreement. There is a very strong case for deepening the existing preferential bilateral agreement on the trade in goods, and for extending it to services and investments. Any bilateral economic agreement India has with Sri Lanka would need not to be driven by market access (given the smallness of our economy) but by its enlightened self-interest in promoting stability and prosperity on its Southern flank. In this connection, it is important that information is made available regarding the positive/negative lists; safeguards; transitional arrangements; and the dispute resolution mechanisms.

It should also be highlighted that it is in the interest of smaller states to negotiate rules-based regimes to manage bilateral relations with much larger trading partners. The asymmetry between the Sri Lankan and Indian economies will increase in the future as the latter emerges as a rising global player in an increasingly multi-polar world. There is, therefore, a strong case, from a Sri Lankan perspective, for placing the increasingly asymmetrical trade and investment relationship between the two countries within a rules-based framework. It is clearly advantageous for Sri Lanka to negotiate the rules earlier rather than later. The challenge is to ensure that the rules serve to advance Sri Lanka's economic interests, while protecting India's strategic concerns.

Strengthening Bilateral Economic Relations

There is significant potential for strengthening bilateral relations in trade**,** investment, technology transfer, knowledge-based innovation and tourism. Improving connectivity will also yield considerable benefits.

Some have argued that the Indo-Lanka Free Trade Agreement (FTA) has been a failure. They cite negative experiences regarding Vanaspathi Oil and Copper (tariff-based arbitrage), a number of non-tariff barriers and the large trade deficit on the Sri Lankan side, to make their case. While the Indo-Lanka FTA has experienced a number of sources of friction, many of them have been addressed and the overall trading environment in goods has improved. However, the disciplinary framework needs to be refined to address the persistent constraints, such as conformity assessment procedures and product standards. These can be addressed, inter alia, through mutual recognition agreements.

Sri Lankan exports to India have increased from 55 million in 2001 to $544 million in 2013. Imports have risen from $568 million in 2000 to $3.2 billion during the same period. This has meant that Sri Lanka's trade deficit with India has increased sharply since the signing of the FTA. However, the aggregate numbers represent a misleading picture regarding the outcomes of the FTA. While most of Sri Lanka's exports enter India on preferential terms, a significant majority of imports from India enter Sri Lanka under Most Favoured Nation (MFN) terms. In this respect, it is noteworthy that Indian imports, which are on Sri Lanka's negative list such as motor vehicles, petroleum products, agricultural goods and paper products have grown significantly as part of normal trade. By being internationally competitive, such imports have not only reduced Sri Lanka's overall trade deficit but also provided its people with access to cheaper goods. There is considerable scope to increase Indo-Lanka trade, particularly Sri Lankan exports.

In this connection, full cognizance should be taken of the nature of global production processes. Currently, intra-firm trade in Asia is the most dynamic component of the international trading system. Supply chain-based trade has been a key explanatory factor for the export success of East and South East Asian countries. As Indian production processes become more complex with the progress expected to be made in PM Modi's 'Make in India' strategy, opportunities will be generated for Sri Lanka to plug into Indian supply chains. The prospects exist to replicate the experience of East and South East Asia associated with the rise of first Japan and then China. Located a mere 20 miles away, Sri Lankan businesses have an unparalleled opportunity to plug into the supply chains of Indian companies and MNCs operating in India, particularly in the four fast-growing Southern states (Andhra Pradesh, Karnataka, Kerala and Tamil Nadu). Plugging into supply chains can be an attractive means of leveraging the expansion of the Indian middle-class and the growth of its disposable income. The prospects for doing so are constantly increasing with the improvement in infrastructure (roads, railways, ports and airports) in both countries. This is reducing transaction costs and is facilitating the opportunities for taking advantage of the premium attached to proximity.

The growing bilateral trade has also created the conditions for increased investment. An increase in Indian investment has already taken place in areas, such as health, education, fuel distribution, tyre and glass manufacture, hotels and tourism, IT training, computer services and professional services. Sri Lanka's continuing lackluster export performance is a major "drag" on the development prospects of the economy. The current problem is basically a lack of competitive supplies. Indian investment can assist in addressing this. Sri Lanka does not produce sufficient goods and services which the rest of the world wants to purchase. It is no longer a low labour cost investment destination. This, therefore, is not an endowment that can be leveraged upon. As a result, the country needs to shift to a more complex export structure. This requires not only investment but also technology, knowledge – based innovation, branding and market access. India is well placed to support Sri Lanka in developing an FDI – driven export structure that diversifies both products and markets. The recent commercial hub legislation can facilitate this process. One may conclude that the trade-investment nexus needs to be strengthened to create competitive supplies which enable Sri Lanka to benefit more from the bilateral preferential trade agreement. This would also serve to reduce the large bilateral trade deficit. It should also be noted that once the Sino – Lanka FTA is completed, Indian investors can also gain preferential access to the massive Chinese market by locating in Sri Lanka.

India already accounts for the highest number of tourists to Sri Lanka. However, considerable scope exists not only to increase the numbers but also the daily spend per head. At present, most of the Indian visitors to Sri Lanka tend to belong to the lower market segment. However, a considerable stock of upmarket inventory is expected to come on stream in the next few years. ITC Sheraton, Shangri La, Hyatt and Movenpick are all building hotels. In addition, approvals have been granted to develop two large integrated resorts: the $815 million Waterfront development (John Keells) and the $350 million Crown (James Packer) investment. All this will cater not only to upmarket tourists but also create the infrastructure for a sharp rise in MICE tourism. Increased access to the higher Indian market segment will be crucial for ensuring the viability of these projects and realizing the considerable potential of the tourism sector.

ICT/BPO is currently the most dynamic component of Sri Lanka's export sector. Export earnings are increasing very sharply. There is considerable potential for increasing this and other services sectors, such as shipping, aviation and financial services through greater collaboration with India. In addition, India can also be the source for accessing very specific categories of skilled labour to meet shortages in the domestic market.

There is also considerable potential for expanding both power and transport connectivity, areas which received high priority at the recent SAARC summit. The combination of the existing generation capacity, Sampur and the prospect of commercializing the natural gas discoveries is likely to create surplus capacity. This opens up the opportunity connectivity with the Indian power grid. In addition, transport connectivity can be enhanced not only through the increased capacity of the Colombo and Hambantota ports and Katunayake airport but also through development of the Kankasanthurai port and Palaly airport; as well as the reopening of the Mannar – Rameswaram ferry.

A Win-Win Future

Expanded Indo-Lanka bilateral economic relations offer significant benefits for both sides. Sri Lanka can benefit from access to a much larger market which will allow the realization of economies of scale; the potential to integrate into large value chains; and access to investments, technology and knowledge-based innovation. In addition, the Indian market is clearly important for the growth of the tourism sector. India, for its part, can demonstrate the value of a productive partnership with a neighbour, which, if emulated, has the potential to stimulate growth and reduce political friction in the neighbourhood, while promoting stability and prosperity on its strategically sensitive Southern flank.

This is the Sixty Eighth Economic Alert of Pathfinder Foundation. Readers' comments are welcome at www.pathfinderfoundation.org