



## **Pathfinder Economic Alert**

### **Why are we so afraid of India?**

#### **Time to grasp the opportunity?**

In recent days, important voices have been raised about the dangers of completing the Comprehensive Economic Partnership Agreement (CEPA) with India and constructing a land bridge between the two countries. It is noteworthy that the focus has not been on exploring whether the CEPA and the land bridge can be favourable for Sri Lanka. Instead, there has been a clamour to throw the baby out with the bathwater. This article seeks to make the case that both the CEPA and the land bridge are opportunities rather than threats. However, it is important that the CEPA is negotiated in a manner that furthers Sri Lanka's interests. The article also makes the case that the land bridge should be seen in the context of a pan-Asian and sub-regional push towards greater connectivity.

#### **Primordial fears**

There are those whose antipathy to India is based on fears which are not evidence-based or rational. Their insecurities stem from historical memories which include invasions from South India in previous millennia. For balance, it is also important to hark back to the mutually enriching civilizational links which stretch back centuries, most importantly through the teachings of arguably India's greatest son, Gautama Buddha.

#### **From suspicion to cooperation**

Innate suspicion among many Sri Lankans of India's motives is also fuelled by her role in funding and training Tamil separatist groups in the years leading up to the Indo – Lanka Accord. This was clearly an intrusion into Sri Lanka's internal affairs and a threat to her sovereignty and territorial integrity. However, it is also important to recognise that after that over 1,000 Indian Peace Keeping Forces (IPKF) soldiers lost their lives fighting to maintain Sri Lanka's territorial integrity. Furthermore, India, and other friendly countries, played important supporting roles in the final defeat of LTTE terror.

It is important to learn lessons from the way France and Germany; Japan & South Korea/China; and Vietnam and the US have all been able to move from conflict to close economic cooperation. It is noteworthy that Vietnam is one of the 12 countries involved in the Trans Pacific Partnership Negotiations - a process initiated by the US – despite the devastating legacy of the 'Vietnam war'.

## **The case for the Indo – Lanka CEPA**

### **Economic rationalism not emotion**

It is important that the debate on the Indo – Lanka CEPA is based on ‘economic rationalism’ rather than emotion based on misunderstanding and misinformation. Hard-headed calculation based on current realities rather than historical fears should be guiding our thinking.

In an ideal world, multilateral trade liberalization and/or unilateral liberalization among major trading partners would be better as there would be no trade diversion. However, given the Doha Round impasse; the slow pace of trade liberalization in India; and the Sri Lankan economy becoming as closed as it was in 1970, there is a case for preferential bilateral agreements, such as CEPA or the FTA with China.

### **Is the Indo – Lanka Free Trade Agreement (ISLFTA) a failure?**

It is argued that the Indo-Lanka FTA has been a failure and that the major outcome has been the sharp increase in our bilateral trade deficit with India. The reality is much more nuanced. Sri Lanka’s exports to India have increased from \$56 million in 2000 to \$625 million in 2014. They have also become more diversified with the emergence of items, such as animal feed, electrical appliances and accessories, ships, paper products, glass and plastic products. About 75% of these exports enjoy preferential access to the Indian market provided by the ISLFTA.

At the same time, imports from India have increased very sharply resulting in Sri Lanka’s bilateral trade deficit growing from \$544 million in 2000 to \$3353 million in 2014. It is important, however, to interpret this seemingly adverse trend carefully. Only about 20% of Indian imports enjoy preferential access to the local market. The rest have entered on MFN terms i.e. they were internationally competitive and provided Sri Lankans with cheaper goods and served to reduce the country’s overall trade deficit i.e. though the ISLFTA has contributed to increasing the bilateral trade deficit, it has served to contain Sri Lanka’s overall trade deficit.

In addition, given the nexus between trade and investment increased trade flows have also helped to catalyse about \$1 billion of Indian FDI into Sri Lanka.

Hence, it is inaccurate to conclude that the ISLFTA has been a failure. However, it is also legitimate to point out that it could have delivered significantly better outcomes. The negative experiences related to Vanaspati oil and copper dented confidence. In addition, the persistence of non-tariff barriers has discouraged Sri Lankan exporters. It is undeniable that the ISLFTA has had a number of problems associated with it. However, it has also provided a framework for addressing these issues. In fact, the trading environment has been improving

and a number of sources of friction have already been addressed. There is more to be done, including a Mutual Recognition Agreement (MRA) to overcome the non-tariff barriers based on conformity assessment procedures and product standards.

### **Why should we complete the CEPA negotiations?**

There are a number of reasons why the overall landscape has improved:

- India has reset its relations with its neighbours in South Asia. It has concluded that peace and prosperity in the sub-region would not only benefit its own development but also create a more conducive environment for pursuing its ambitions as a rising global power. It does not wish to be distracted by irritations in the neighbourhood (Indo-Pakistan relations are a special case). Significant advances are already underway in India's relations with Bangladesh, Bhutan and Nepal in areas such as power generation and grid connectivity as well as road and rail transit.
- Improving infrastructure in both Sri Lanka and India is reducing transaction costs and increasing the advantages of proximity.
- PM Modi's 'make in India' strategy is likely to generate new opportunities to plug into the supply chains of companies operating in India, both domestic and MNCs.
- The anticipated introduction of the General Sales Tax (GST) will also improve the ease of exporting into the Indian market as it will result in the elimination of a number of state-level taxes and levies. It would be a significant advance in the move towards a single market in India.
- India has accepted the principle of 'non-reciprocity'. This offers Sri Lanka an opportunity to take advantage of trade measures such as negative lists, safe-guards against import surges and differentiated transitional arrangements to increase the potential benefits from the CEPA.
- It is in the interests of smaller countries to seek a rules-based regime to manage relations with much larger trading partners. In the absence of such a disciplinary framework everything has to be negotiated on a case-by-case basis. The asymmetry between the Sri Lankan and Indian economies will grow over time. In addition, India is Sri Lanka's largest trading partner. This amplifies the need for a rules-based agreement, such as CEPA, particularly as it offers the possibility of strengthening the dispute-resolution process at a time when the asymmetry between the countries will increase as Indian growth accelerates.
- An on-going World Bank study has concluded that greater trade integration with India can generate significant gains for the smaller countries of South Asia. Sri Lanka can benefit from preferential access to a large market which will allow the realization of

economies of scale; the opportunity to integrate into large value chains; and access to investment which can bring in markets, technology and know-how.

- There is also a strong case to complete the CEPA quickly as India has already negotiated preferential trade agreements with other countries and is in the process of completing further agreements. Sri Lanka is already in danger of losing its first-mover advantage. In addition, if delay leads to a reduction of Indian tariff levels, the preferential advantages from the CEPA would also be eroded.
- There is a strong case for extending the current FTA in goods to include services and investment.
  - There is a general consensus that with the rise in wages, Sri Lanka has a greater competitive advantage in services exports e.g. shipping, aviation, ICT/BPO/KPO, financial services, etc. Shipping and logistics is clearly a strength because of Sri Lanka's strategic location and the efficiency of the Colombo port. It would be illogical not to include services in the bilateral rules-based agreement when this sector offers much scope for growth and India has accepted the principle of non-reciprocity. Despite the scare stories, the reality is Sri Lanka will be opening-up very little beyond what is already available under existing legislation, such as the BOI Act. Claims that the country will be flooded by professionals and barbers are not founded on facts as very few sectors will be opened up i.e. areas such as IT and ship-building where there is a scarcity of local skills.
  - It is also important to include investment. The nexus between trade and investment is crucial for maximizing benefits from trade agreements between asymmetrical economies. Increased Indian investment will generate exports back to India. This is the best way of addressing the current large trade deficit between the two countries. Increased Indian investment can also generate more exports to Pakistan and China (anticipated) using the FTA's with those countries. Sri Lanka can act as a bridge using the three agreements to its advantage.

### **The case for the land bridge**

Throughout Asia, there is a gathering momentum to improve connectivity. As mentioned above, there is considerable progress being made in this regard in the North East of the South Asian sub-continent. In addition, the Asian Development Bank and China (through its land and Maritime Silk Route initiatives as well as the Asian Infrastructure Investment Bank) are in the vanguard in developing infrastructure which will improve connectivity between the different sub-regions in Asia.

South Asia is being connected to the East through Myanmar and South East Asia. Links with Central Asia are being improved through Pakistan. The proposed land bridge will connect Sri Lanka to the emerging pan-Asian network of roads. Countries like Bangladesh, Bhutan and

Nepal, which have had a troubled history with India, have acquired the foresight to grasp that increased connectivity with the fastest growing large economy in the world is an opportunity rather than a threat. In this connection, it is important that Sri Lanka acquires the self-confidence to overcome its insecurities.

It is a truism that if India ever decided to compromise Sri Lanka's sovereignty it has the capacity to do so, with or without a land bridge (e.g. the Parippu drop). However, the land bridge has the potential to open up a range of new commercial opportunities for Sri Lankan businesses through improved connectivity to the Indian sub-continent and beyond.

### **Postscript**

Other countries in the region and the rest of the world (including ASEAN, China, Europe, Japan, South Korea and the US) see India as an increasing opportunity. It would be highly counterproductive if Sri Lanka chooses to undervalue what is available at its door step. A failure to transcend narrow-minded fears and insecurities would deprive Sri Lanka and its people from taking advantage of a potentially transformative opportunity to boost their development prospects.