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The Pathfinder Economic Alert

CEPA: Betrayal or Transformative Opportunity

Lost Opportunities and Challenges

Recent press reports have indicated that all the ASEAN member countries have now ratified a Comprehensive Economic Partnership Agreement (CEPA) with India. This agreement is expected to come into effect by the end of 2011. Sri Lanka had a head start when the Indo – Sri Lanka Free Trade Agreement (ISLFTA) was implemented in 2000 and negotiations were commenced on an Indo – Lanka CEPA in 2003. The news of all ASEAN countries ratifying their CEPA with India, at a time when the Indo – Lanka agreement has stalled, raises the question whether Sri Lanka is about to miss a second transformative opportunity in a generation.

The first such opportunity emerged in the 1980s. At that time, Japan had extremely large trade surpluses and, like China today, was under considerable pressure to appreciate its currency. Following the Plaza and Louvre G7 Accords, Japan permitted the Yen to appreciate significantly. At the same time, the Japanese authorities took a strategic decision to take advantage of the strength of their currency by exporting capital to establish production capacity abroad. This was intended to compensate for the loss in the competitiveness of their exports as a result of the appreciation of the Yen. At that time, Sri Lanka was identified as one of four countries that would be targeted as strategic locations for Japanese investment. The other countries were Indonesia, Malaysia and Thailand. These countries experienced a step-jump in their development trajectories in the mid- 1980's. Japanese foreign direct investment (FDI) was a very significant causal factor.

Unfortunately, the 1983 ethnic disturbances taking place at the very time a delegation of 35 potential Japanese investors were in Colombo; the death of young Japanese honeymooners when a Air Lanka plane was blown up on the tarmac at Ratmalana; and the killing of a Japanese priest who was marching for peace in Jaffna all acted as deterrents for Japanese investment in the country. Though Japan has been Sri Lanka's leading bilateral aid donor for many years, FDI from that country has been negligible. The other three countries, mentioned above, benefited from millions of dollars of Japanese FDI, which served to provide a major boost to exports, growth and employment in these economies. Sri Lanka missed out completely.

A previous Economic Alert highlighted the favourable economic geography that Sri Lanka currently enjoys, being located in the dynamic Asian region and a mere 20 miles away from the large and fast- growing Indian market. The question that now needs to be asked is whether Sri Lanka is in danger of missing another transformative opportunity. The debate on the merits of the Indo-Lanka CEPA, as a means of taking advantage of our proximity to a resurgent India, seems to divide the protagonists on the basis of whether India is seen as an "opportunity" or a "threat". Some of the antipathy to the Indo – Lanka CEPA is based on primordial fears and insecurities which are not evidence based or rational. However, there is also more considered opposition based on the following argumentation which requires careful examination.

- The asymmetry of the two economies means that the CEPA would inevitably be detrimental to Sri Lanka's interests resulting in a loss of output (growth) and employment.
- The ISLFTA has been a failure with more costs than benefits for Sri Lanka.
- The CEPA would inevitably lead to greater Indian intrusion into the domestic affairs of Sri Lanka leading to an erosion of sovereignty.

Asymmetry of the Two Economies

The argument that the asymmetry in the size of the two economies would preclude a mutually beneficial CEPA ignores some important facts. There are provisions in all trade agreements for negative lists and safeguards. There can also be differences in the time periods over which the parties liberalize trade in the items on the positive list. The Indian authorities, particularly Prime Minister Manmohan Singh, have shown a sensitivity to the need for the principle of reciprocity to be applied in a manner that takes into account the asymmetry of the two economies i.e. Sri Lanka has room for maneuver when it comes to the negative list, safeguards and the speed of liberalization. The focus, therefore, should be on negotiating to maximize the benefits for Sri Lanka through, among other things, effective use of these mechanisms. Sri Lanka has trade negotiators, who are widely respected at home and abroad. They have the capacity to negotiate effectively on behalf of the country

It is also likely that the economic asymmetry between Sri Lanka and India is going to increase in the future as the latter emerges as a major global player in an increasingly multi-polar world. This increases the need for a rules-based regime to manage Sri Lanka's bilateral trade and investment relations with India. This has become particularly important in the absence of progress on multilateral (Doha round) and plurilateral (SAFTA) frameworks. This line of argument contends that there is a case for negotiating the CEPA sooner rather than later in a context where the power relations between the two countries are likely to become more asymmetric. Furthermore, with the ratification of an Indo – ASEAN CEPA some competitor countries seem to be stealing a march on Sri Lanka in terms of benefiting from the rapid growth in India.

One may conclude that there is a strong case for putting the increasingly asymmetrical trade and investment relationship between Sri Lanka and India within a rules-based framework; and it is also advantageous to negotiate the rules earlier rather than later as the current Indian government has demonstrated that it has been sympathetic to Sri Lanka's interests both during the end period of the war as well as its immediate aftermath. Furthermore, an effective Indo – Lanka CEPA would also provide Sri Lanka with a head start in taking advantage of rapid growth in India in the event there is progress on the Doha Round or SAFTA.

It is generally recognized that it is in the interests of small states to negotiate a rules-based regime to manage bilateral relations with much larger trading partners. The challenge is to ensure that the rules serve to maximize Sri Lanka's interests. However, one also needs to be realistic and recognize that all trade agreements will have both "winners" and "losers". The objective should be to ensure that there are many more "winners" than "losers". It is also a fact of life that the voices of the losers, even if they are much smaller in number, will always be much louder than those of the winners, who usually choose to be a "silent majority". This happens in all countries and the debate on the Indo – Lanka CEPA seems to fall very much into this stereo – type.

A combination of a judicious negative list, safeguards and transitional arrangements can result in a CEPA which provides a rules-base framework for taking advantage of the rise of India in a predictable and stable environment. It is noteworthy that the ASEAN countries, which have ratified the CEPA with India, comprise both economies that are somewhat more developed than Sri Lanka (e.g. Malaysia, Thailand and Vietnam) as well as those that are less advanced (e.g. Cambodia, Laos and Myanmar). Countries, which are as diverse in their economic development as Singapore and Cambodia/Laos, have ratified the CEPA with India. They have concluded an agreement which they believe will be beneficial for them. If such a range of countries consider it advantageous to have a CEPA with India, it raises the question why Sri Lanka should be fearful of the impact of a CEPA on investment, growth and employment in this country.

A study undertaken for the Pathfinder Foundation has pointed out that CEPA can offer significant benefits for both sides. Sri Lanka can benefit from a larger market that will allow the realization of economies of scale, the ability to integrate into large value chains as well as access to investment. 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.

The proposed Indo – Lanka CEPA would refine the existing disciplinary framework for the trade in goods by addressing major issues that have hitherto constrained benefits from the ISLFTA. These include conformity assessment procedures and product standards. It will also introduce rules-based regimes for trade in services and investment as well as strengthen the dispute – resolution process.

The Indo – Sri Lanka Free Trade Agreement (ISLFTA)

Some have argued that the ISLFTA has failed. They cite negative experiences regarding Vanaspathi oil and copper, as well as a number of non- tariff barriers, to make their case. The ISLFTA has certainly had a number of problems associated with it. However, it has also provided a framework for addressing these issues. The trading environment in goods has improved and a number of sources of friction have already been addressed.

Sri Lankan exports to India increased from $55 million in 2000 to $566 million in 2005. Since then they have declined to $418 million in 2008 and $322 million in 2009. The decline in exports to India during the period 2007 – 2009 may be attributed to reduction in vegetable oil, primary copper and pepper. However, it is noteworthy that the limited basket of exports to India at the inception of the ISLFTA was diversified during the period 2007 – 09 with the emergence of new items such as animal feed, electrical appliances and accessories, vessels, paper products, glass and plastic products. This happened despite the significant appreciation in the real effective exchange rate during this period.

Imports from India have increased from $568 million in 2000 to $3447 million in 2008, and subsequently declined to $1820 million in 2009. The decline in 2009 may be explained by the overall slowdown in the economy and the resulting import compression during that year. Major imports from India, in 2009, included petroleum products, iron and steel, cotton, motor cycles and motor vehicles.

Sri Lanka’s trade deficit with India has grown from $531 million in 2001 to $3029 in 2008. It t