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**Sri Lanka's Free Trade Agreements with its South Asian Neighbours:
Economic Versus Strategic/Political Considerations**

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Abstract

In recent years, regional trade or free trade agreements (RTAs or FTAs) have proliferated around the world. These RTAs differ vastly in terms of memberships, scope, coverage and motivations. There are different reasons and motivations for forming RTAs in different parts of the world. The recent surge of RTAs cannot be examined by using any "one-size-fits-all" explanation. Very often the purpose of integration is political and the economic consequences are side effects of political decisions. Most of the economic analysis and commentary on RTAs has focused on the economic effects. In empirical studies of RTAs, potential political benefits or actual political benefits of RTAs in terms of externalities have been ignored. The South Asian countries have been engaged in forming bilateral or plurilateral RTAs within the region without much economic gains since the 1990s. It would be natural to explore why these countries are continuing in forming RTAs within the region. A likely answer to this question would be that the motivations behind forming RTAs within the region are not purely based on the potential economic benefits. The strategic and political considerations may very well be more important to member countries. The purpose of this paper is to address this issue using two bilateral FTAs signed by Sri Lanka respectively with India and Pakistan as examples. More specifically, by examining economic gains of Sri Lanka's FTAs with India and Pakistan, it attempts to answer the question: does a bilateral FTA lead to an improvement of security of a member country and greater peace between two member countries? In this paper we argue that Sri Lanka managed to increase its security by neutralising the pressure from India and gaining military and strategic support from Pakistan for its current war in the north of the island.

1. Introduction

The last two decades witnessed a proliferation of bilateral or plurilateral regional trade or free trade agreements (RTAs or FTAs) around the world. It is now hard to find a WTO member country without having a membership in at least one RTA. Some WTO member countries have even become members of several or a large number of such agreements. These RTAs differ vastly in terms of memberships, scope, coverage and motivations. There are different reasons and motivations for forming RTAs in different parts of the world. As Fernandez and Portes (1998, p.217) have pointed out, the recent surge of RTAs cannot be examined by using any "one-size-fits-all" explanation. The World Bank (2000, p.11) has noted that "the purpose of integration is often political, and the economic consequences, good or bad, are side effects of the political payoff". Most of the economic analysis and commentary on RTAs have focused on the economic effects. In recent years a large number of studies have been carried out to quantify only the economic impact of these agreements by using two main quantitative approaches; the gravity models (GM) and the computable general equilibrium (CGE). In all of these empirical studies potential political benefits or actual political benefits of RTAs in terms of externalities have been ignored. Although this is understandable, political and strategic importance of RTAs has long been neglected with few exceptions (see for example, Schiff and Winters, 1998a and

1998b, and World Bank, 2000).

In comparison with other parts of the world, South Asian countries were not actively involved in forming RTAs until the late 1990s with the exception of the Bangkok preferential trading agreement (now known as the Asia Pacific Trade Agreement, APTA). Even though South Asian countries are relatively new in forming trade blocs, a number of bilateral and plurilateral RTAs have recently been signed by countries in the region. Sri Lanka, a relatively small country in this region, has become a member of several RTAs such as the Asia Pacific Trade Agreement (APTA), the South Asian Free Trade Agreement (SAFTA), the India-Sri Lanka Free Trade Agreement (ISLFTA) and the Pakistan-Sri Lanka Free Trade Agreement (PSLFTA). Proponents of these South Asian FTAs argue that there are significant potential economic benefits to be captured from these agreements, but the potential benefits may not be fully realized due to the existence of serious political disputes and mistrust among countries in the region. They further believe that South Asian RTAs like SAFTA are vehicles for political harmony in the region. On the other hand, opponents of these agreements argue that potential economic gains from these FTAs are likely to be small and it is not advantageous for these countries to advocate FTAs within the region since these countries are poor and have similar economic structures and factor endowments. They further argue that countries in the region would be better off looking beyond South Asian regionalism and joining bigger Asian FTA with countries like China and ASEAN countries. They also believe that the expected political gains from SAFTA have not been materialised, particularly the expected political harmony between India and Pakistan (see Panagariya, 2007).

Following the strong argument against forming FTAs within South Asia, it would be natural to explore why these countries are continuing in forming FTAs within the region. A likely answer to this question would be that the motivations behind forming FTAs within the region are not purely based on the potential economic benefits. The strategic and political considerations may very well be more important as noted above. The purpose of this paper is to address this issue using two bilateral FTAs signed by Sri Lanka respectively with India and Pakistan as examples. More specifically, by examining economic gains of Sri Lanka's FTAs with India and Pakistan, it attempts to answer the question: does a bilateral FTA lead to an improvement of security of a member country and greater peace between two member countries? In this paper we argue that Sri Lanka managed to increase its security by neutralising the pressure from India and gaining military and strategic support from Pakistan for its war against the separatist group, the Liberation Tigers of Tamil Eelam (LTTE) or commonly known as the Tamil Tigers², after signing ISLFTA and PSLFTA.

The rest of this paper is structured as follows. The next section briefly reviews the literature related to non-economic gains from RTAs. Section 3 provides a brief overview of Sri Lankan post independence trade policy and Section 4 presents the main characteristics of ISLFTA and PSLFTA. An analysis of economic gains of two FTAs is presented in Section 5. Section 6 explains how Sri Lanka gained from two bilateral FTAs politically and militarily. The final

² This group has been banned as a terrorist group in countries like India, the US, UK and Canada.

section is devoted to concluding remarks.

2. A Brief Literature Review

Despite the importance of non-economic factors behind RTAs, economists and policy analysts have not paid much attention to underlying political and strategic motivations of countries forming bilateral or plurilateral trade agreements as noted in the introduction. Very often they are focusing on the economic benefits, known as “traditional” gains, in evaluating the impact of a RTA ignoring other gains such as positive security externalities and other strategic benefits. This approach is sometime misleading when considering the participation of a small developing country in forming bilateral and plurilateral trade agreements. As pointed out by Schiff and Winters (1998a, p.178), “understanding the potential linkages between favouritism in trade and the pursuit of noneconomic political and social objectives can be crucial in a developing country’s decision to participate in an RTA”. Although the majority of economists and policy analysts have not paid much attention to non-economic motivations behind RTAs, there has been a growing interest among some on this topic. In this section we briefly review this literature in order to provide a foundation for our study.

Over the last two decades or so a group of researchers led by Polachek have been focusing on the link between trade and conflict using detailed statistical and empirical studies (see for example, Polachek, 1980, 1992, 1997; Gasiorowski and Polachek, 1982; Polachek and McDonald, 1992). This literature clearly demonstrates that the “fundamental factor in causing bilateral cooperation is trade” and “countries seek to protect wealth gained through international trade, therefore, trading partners are less combative than non-trading nations” (Polachek, 1997, p.295). Using a detailed empirical research on bilateral trade and conflict Polachek (1997, p.300) finds that “the greater the level of trade country pairs engage in, the lower the conflict between them, even when adjusting for country attributes”. Further he finds that a decline in conflict between 0.15 – 0.16% resulted from an increase in bilateral trade by 1% according to elasticities of conflict with respect to trade. In other words his empirical study suggests that doubling trade between two countries would reduce the risk of conflict by about 15-16%. The message emerging from the studies of Polachek (1992, 1997) is that bilateral free trade tends to reduce conflict and increase cooperation.

About a decade ago the World Bank initiated a research program on regionalism and development focusing on both static and dynamic effects of RTAs. This program also focused on the politics and political economy of RTAs. Six research papers out of this research program were published in the *World Bank Economic Review* in 1998 highlighting the importance of political and strategic gains of RTAs (see for example, Schiff and Winters, 1998a and 1998b). Schiff and Winters, (1998a, p.186) clearly demonstrate the importance of non-economic motivations of RTAs stating that “we accept at face value the premise that trade among neighbouring countries provide security directly, for example, by raising the level of interaction and trust among the people of those countries, by increasing the stake that each country has in the welfare of its neighbour, or by increasing the security of access to the neighbour’s strategic raw materials”. Schiff and Winters (1998b, p.288) have examined “the logical implications of positive security externalities that may result from trade between suspicious neighbours” using a simple model. They demonstrate that security with a neighbour increases as imports from that

neighbour increase by using a simple set of assumptions.

After reviewing literature, a World Bank report has clearly articulated the political and strategic significance of RTAs on a number of grounds (World Bank, 2000, p.28). Firstly, negotiations between political leaders in forming RTAs gradually build trust and subsequently force leaders to learn how to form cross-national coalitions and formulate policies for cooperation. Regular contacts and meeting between leaders in two countries further develop close relationships. Secondly, forming RTA's may help to increase security against non-members. This argument was used for European integration a few decades ago. Finally, RTAs may help to reduce internal conflicts and promote interregional security. This argument follows the early research led by Polachek.

Considering the recent shift in the US trade policy towards regional and bilateral initiatives, Feinberg (2003) has reviewed a range of non-economic factors involved in US regional initiatives with other developed and developing countries. According to this study, strengthening strategic partnerships has been one important motivation for the US to participate in a large number of bilateral FTAs and Comprehensive Economic Partnership Agreements (CEPAs) since the enactment of the US Trade and Development Act in 2000. Feinberg (2003, p.1028) has further highlighted that the importance of the US security interests in signing FTAs with countries such as Canada, Mexico, Singapore, Australia, Israel, Jordan and Morocco as well as joining other RTAs such as FTAA, APEC and SACU. Since Australia has been a friendly and loyal ally, US did not hesitate to sign a FTA with Australia over New Zealand. Similarly, the US has turned down a request from Taiwan to form a FTA to avoid conflict and security threat from China (see Feinberg, 2003 for details). The US has also initiated bilateral agreement with three South Asian countries (Bangladesh, Pakistan and Sri Lanka) by signing Trade and Investment Framework Agreements (TIFAs). In return, the US is implicitly expecting support for its military activities such as wars in Iraq and Afghanistan, military exercises in the Indian Ocean and free access to ports in these countries.

Panagariya (2007, p.184) points out that "SAFTA is also seen as a vehicle of promoting better political ties among neighbours, especially India and Pakistan, which have had a long history of rivalry". In contrast to the success story of the European Union, SAFTA is far away from meeting this objective considering the political conflicts between two leading members, India and Pakistan. The countries in the region now have realised making bilateral arrangements is the second best option for achieving such political goals. Sri Lanka's bilateral links with India and Pakistan can be considered as an excellent example in this regards which will be the subject matter of the rest of this paper.

Two important messages emerge from our brief literature survey in this section. Firstly, the empirical research on the link between bilateral trade and peace clearly indicates that trade tends to reduce political conflicts between trading partners. Secondly, it is obvious that security considerations of one type or another have often been a significant motivating factor for forming bilateral and plurilateral trade agreements. As World Bank (2000, p.17) summarises "the economic consequences of such integration are thus side effects of political decisions". It further emphasises that "sometimes the economic effects will be favourable so that integration offers politicians both political gains, such as enhanced security, and economic gains" and

“sometimes the economic effects will be unfavourable, facing decision makers with a tradeoff” World Bank (2000, p.17).

3. Sri Lanka's Post-Independence Trade Policy

After gaining independence in 1948, Sri Lanka implemented a protectionist trade policy regime until the late 1970s except for a brief episode of open economic policies in the early 1950s and a partial liberalisation episode during the period of 1965-1970. There was a drastic shift in trade policy in 1977 when Sri Lanka opened its economy to the outside world by introducing a trade policy reform package. Since the late 1970s the economy has been relatively open and there has been a continuation of the open economic trade policy regime. Previous research on Sri Lankan trade policy reviews the evolution of trade policy and we do not intend to repeat them in this paper; rather, we briefly summarise various elements of current trade policy stance³.

As shown in Table 1, Sri Lanka has been actively involved in trade liberalisation by using a number of avenues such as unilateral and multilateral trade liberalisation, and plurilateral and bilateral trade agreements in recent years. Unilaterally, Sri Lanka introduced a trade liberalisation process in 1977. Since then successive governments have continued with open economic policies over the last three decades or so. As a member of WTO, Sri Lanka is also involved in multilateral trade negotiations and trade liberalisation under the WTO agreements. Since the 1990s joining and negotiating bilateral and plurilateral trade agreements have been another ingredient of Sri Lankan trade policy. It is now pursuing bilateral and plurilateral trade agreement and considering them as complementary to open economic policies and SAFTA. As shown in Table 1, it is active in forming both geographically connected and disconnected RTAs. In terms of geographically connected plurilateral (or multilateral) trade liberalisation, Sri Lanka has been an active member of South Asian Association for Regional Cooperation (SAARC) formed in 1985. Under the umbrella of SAARC seven member countries (Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka) formed the South Asian Preferential Trading Agreement (SAPTA) in 1995. In 2005 SAPTA was transformed into the South Asian Free Trade Agreement (SAFTA). Sri Lanka has been actively involved in the journey of SAARC to SAFTA as a geographically connected regional trading agreement. In addition to SAFTA, Sri Lanka is also playing an active role in the geographically connected Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMST-EC) which involves countries like Bangladesh, Bhutan, India, Myanmar, Nepal Sri Lanka and Thailand. Currently, these countries are engaged in negotiations to form another FTA. The Indian Ocean Rim Association for Regional Cooperation (IOR-ARC) can also be considered as another geographically connected regional initiative. Members are Australia, Bangladesh, India, Indonesia, Iran, Kenya, Madagascar, Malaysia, Mauritius, Mozambique, Oman, Singapore, South Africa, Sri Lanka, Tanzania, Thailand, the United Arab Emirates, and Yemen. Although the progress towards a RTA has been very slow, Sri Lanka is actively promoting a RTA within IOR-ARC.

Sri Lanka has long been pursuing geographically dispersed regionalism as well. For example, it

³ see for details, Cuthbertson and Athukorala, 1990; Athukorala and Jayasuriya, 1996 and Athukorala and Rajapathirana, 2000 for detailed discussions on trade liberalisation in Sri Lanka.

has been an original member of one of the oldest RTAs in the world, the Asia Pacific Trade Agreement (APTA) which was known as the Bangkok Agreement. The members of this agreement include India, China and Thailand. For political and economic reasons, Sri Lanka attempted to join the Association for South East Asian Nations (ASEAN) in 1967 although it failed. In 1992, it again unsuccessfully attempted to join ASEAN and that attempt was also failed. In recent years, Sri Lanka has managed to establish some close links with ASEAN. As a result of latest attempts, it was able to join the ASEAN Regional Forum (ARF) as its 27th member at the 14th ARF meeting held in Manila in August 2007. This is the highest level forum in the Asia-Pacific region which deals with issues concerning defence cooperation and security, including terrorism, money laundering, illicit trafficking of narcotics, and weapons and human smuggling as well as cooperation between armed forces of Member States.

Sri Lanka has also been initiating a number of geographically connected and geographically disconnected bilateral trade agreements. As shown in Table 1, it successfully implemented the geographically connected India Sri Lanka Free Trade Agreement (ISLFTA) in 2000 and Pakistan Sri Lanka Free Trade Agreement (PSLFTA) in 2005. In addition to these two FTAs it has currently been involved in negotiating geographically connected bilateral trade agreements with Bangladesh and Nepal.

In addition to geographically connected bilateral trade agreement, Sri Lanka is pursuing geographically disconnected bilateral agreements as well based not only on economic gains but also on political and strategic grounds. During the period of peace talks between the Sri Lankan government and the LTTE in 2002 and 2003 the US maintained a close diplomatic relationship with Sri Lanka and signed a new TIFA in 2002 to strengthen economic relationships. However, the collapse of CFA, disagreements with conditions and the change in political environment in Sri Lanka have contributed to the failure of forming an FTA between the two countries so far. The US administration is also under constant pressure from the Tamil Diaspora and international non-governmental organisations (NGOS) not to support of the Sri Lankan government's current military strategy.

With the beginning of the military offensive against the LTTE since 2006 Sri Lanka, has established or strengthened diplomatic and economic ties with non-western countries like Iran, China and Russia. There is diplomatic pressure from member countries of EU and the US on Sri Lanka to stop the war and enter into a cease fire agreement (CFA) with the LTTE. According to some observers, commentators and government politicians in Sri Lanka there is a western conspiracy against Sri Lanka as an attempt to put pressure on the Government to stop the war and enter into another CFA. Some of the EU countries have already made attempts to isolate Sri Lanka economically by reducing foreign aid and threatening to remove GSP+ status on the ground of alleged human right violations. Because of this threat of isolation from western countries, particularly from the EU, the current Sri Lankan government led by the President Mahinda Rajapakse has attempted to establish close links or improve existing links with non-western trading partners such as Iran, China and Libya. Iran has become an important trading partner and foreign aid donor of Sri Lanka over the last few years and the government is continuing to expand its trade and economic relationship with Iran. During the Sri Lankan visit of the Iranian president in 2008, the two countries have signed six Memoranda of Understandings (MOUs) related to different projects. Sri Lanka also hopes to formulate bilateral

trade agreements with countries like Bangladesh, Egypt, Singapore and Iran in the future (ADB, 2006).

Table 1: Categorisation of Modes of Trade Liberalisation of Sri Lanka

	Actor Scope				
	Unilateral	Bilateral	Plurilateral	Multilateral	
	Geographically Concentrated	Geographically Dispersed	Geographically Concentrated	Geographically Dispersed	
Trade liberalisation measures	ISLFTA (operational) PSLFTA (operational) BSLFTA (proposed) NSLFTA (proposed)	TIFA with US (signed) Egypt-SLFTA* Iran-SLFTA* Singapore-SLFTA*	SAFTA BIMST-EC IOR-ARC	Asia-Pacific FTA	WTO/Doha Round
	Unilateralism	Bilateral Regionalism	Bilateral transregionalism	Regionalism	Transregionalism
					Globalism

Note: Following the method of classification of Aggrawal (2001) and Feinberg (2003).

* Under consideration (as listed in ADB, 2006)

4. An Overview of ISLFTA and PSLFTA

As mentioned in the previous section, Sri Lanka has been successful in signing two bilateral FTAs with its two giant neighbours. The purpose of this section is to provide an overview of these two FTAs. While the ISLFTA was implemented in 2000 after signing in 1998, the PSLFTA was implemented in 2005 after signing in 2003.

The basic characteristics of the two agreements are summarised in Table 2. Many bilateral and plurilateral agreements are often based on the 'positive list' approach (each participating country prepares a list of commodities for which it would grant tariff concessions to other participating country or countries). However, both ISFTA and PSFTA are based on the 'negative list' approach (each participating country prepares a list of items which are sensitive and excluded from the tariff concessions). According to Table 2, countries have agreed to reduce tariffs on some items to zero immediately after two FTAs were implemented and phasing out tariffs on some items during certain time frameworks except for the items in negative lists. Under both agreements there are a small number of important items which are subjected to tariff rate quotas (TRQs) and margin of preferences (MOP). Sri Lankan export items such as tea and garments to India and Pakistan are subjected to TRQs under FTAs.

This table also reflects that there are still a large number of items in negative lists of both agreements. While Sri Lanka included 1180 and 697 items in its negative list of ISLFTA and PISFTA respectively, India included 429 items and Pakistan included 541 in their negative lists. According to the big picture, these numbers indicate that concessions granted to Sri Lanka were generous by both countries. However, a close look at the details of items for which Sri Lanka has comparative advantage and the capability to export have been either included in negative lists or restricted by using TRQs and MOPs by both countries. As demonstrated by Baysan, et al, (2006, p.5), 15 out of the top 20 Sri Lankan export items to the world at the 6-digit HS level are subjected to export restrictions to the Indian market under the ISLFTA. The rules of origins (ROOs) are similar in both agreements (see table 2) and they are highly restrictive too.

Recently both India and Sri Lanka have completed all of their trade liberalisation commitments with the final tariff liberalisation by Sri Lanka effective from November 2008 under the ISLFTA. Currently India and Sri Lanka are in the process of finalising the Comprehensive Economic Partnership Agreement (CEPA) as an extension of the present ISLFTA after the conclusion of discussions on the CEPA framework agreement (Central Bank of Sri Lanka, 2009, p.107). Under such an agreement, two countries are expecting further liberalisation of trade and services and removal of other restrictions. Similar to the process of transforming ISLFTA to a CEPA, Pakistan and Sri Lanka have agreed to extend PSLFTA to a CEPA in order to expand the scope of trade liberalisation to cover more goods, services and investment. A number of rounds of negotiations have been concluded on this CEPA as well.

As a result of ongoing negotiations under Comprehensive Economic Partnership Agreement (CEPA) between Sri Lanka and India, India has removed restrictions on entry ports (as shown in table 2) and sourcing of fabrics for 3 million pieces of apparel products from Sri Lanka to India at zero duty, out of the available Tariff Rate Quota (TRQ) of 8 million pieces of apparel products under the Customs Notification No. 52/2008 dated 22nd April 2008. The above notification has also removed port restrictions on the balance of 5 million pieces of apparel products and these

are allowed to export at zero duty or MOP of 75 percent depending on the use of Indian made fabrics in manufacturing such products (see Department of Commerce Website).

Immediately after signing the PSLFTA, Pakistan has granted duty free access for items such as coconut products, natural rubber, spices, paper boards, articles of aluminum, natural graphite etc. It also granted restrictive concessions for Sri Lankan products such as tea (under TRQ), betel leaves (TRQ) and ceramic products (MOQ). As the final phase of liberalization under the agreement Pakistan granted duty free access for more than 4,000 items such as fish products, meat Products, vegetables, vegetable products, foliage and plants, sugar, biscuits, bakery products, mineral products, fiber boards, leather and leather products, footwear, value added copper products, gems and jewellery with effect from 20 March, 2009.

Table 2: Summary of Commitments by Members under ISFTA and PSFTA

	ISFTA	PSFTA
Important dates	Signed: December 1998 Implemented: March 2000 Completion date of full implementation: 2008	Signed: August 2002 Implemented: June 2005 Completion date of full implementation: 2010
Number of items covered by 100% tariff cuts immediately (or tariffs reduced to zero)	1351 by India (out of 5112 items at HC 6 digit level negotiated) 319 by Sri Lanka (out of 5112 items at HC 6 digit level negotiated)	206 by Pakistan 102 by Sri Lanka
Tariff phase out	India agreed to phase out tariffs on balance items (2797) by March 2003 in two stages (90% first year and 100% by the end of third year) and Sri Lanka agreed to phase out tariffs on balance items by 2008 in two stages (889 items in 3 years and 2724 items in 8 years)	Pakistan agreed to phase out tariffs on balance items (4477) in three years (by June 2008) and Sri Lanka agreed to phase out tariffs on balance items (4425) in five years (by June 2010)
Items subject to tariff rate Quota (TRQ)	Indian TRQ offers: Tea – 50% preferential market access on the March 2000 applied MFN rate for a quantity of 15mn kg per year (specific ports – Kolkata and Kochin); Garments (233 items) – 50 % preferential market access on applied MFN for a quantity of 8mn pieces of which 6mn pieces should contain Indian fabric and no category of garments can exceed 1.5 million pieces per annum (specific ports – Chennai, Kolkata, Mumbai, Nava Sheva). This port restriction was relaxed in 2007. Sri Lanka TRQ offers: Nil	Pakistan TRQ offers: Tea – Duty free access for 10,000MT per financial year (July-June); Garments – 3mn pieces under 35% preferential market access per financial year; Betel leave – 1,200MT under 35% preferential market access per financial year. This was removed and introduced a MOP (reduction of tariffs from 35 to 20%) . Sri Lanka TRQ offers: Basmati rice – 6000 MT under duty free access per calendar year; Potatoes – 1000 MT under duty free access per year.
Items entitled for margin of preference (MOP)	India- Textiles: 25% MOP on applied duty rate for 553 items Sri Lanka TRQ: Nil	Pakistan: Ceramics products – 20% MOP on applied MFN duty rate for ceramic tiles, tableware and kitchenware; cosmetic product – 50% MOP on applied MFN duty rate; .
Rule of origin	35% domestic value added or 25% Indian (or Sri Lankan) value added if 10% of Indian (or Sri Lankan) inputs are used. HS code transformation at the 4 digit level	35% domestic value added or 25% Pakistan (or Sri Lankan) value added if 10% of Pakistan (or Sri Lankan) inputs are used. HS code transformation at the 6 digit level
Number of items covered by the negative list	India: 429 (includes TRQ items) Sri Lanka: 1180 (includes TRQ and MOP)	Pakistan: 541 (includes TRQ and MOP items) Sri Lanka: 697
Further liberalisation	Negotiations are underway for a Comprehensive Economic Partnership	

Sources: <http://www.boi.lk>; Kelegama and Mukherji (2007); Perera (2008); Yatawara (2007) and EDB (2008)

5. Economic Gains from ISLFTA and PSLFTA

Both FTAs have provided Sri Lankan exporters with some opportunity to access the two largest markets in the region with 1.15 billion people in India, the second largest populated country in the world, and 172.8 million people in Pakistan, the sixth largest populated country in the world. Despite security concerns in the region, growth rates in India and Pakistan have been impressive in recent years (around 8 percent in India and around 6 percent in Pakistan over the recent years). In this section we first analyse whether Sri Lanka has managed to take advantage of the two FTAs to increase its exports to India and Pakistan using trade data. Following this qualitative analysis, we use the GTAP model to analyse the potential economic impact of full trade liberalisation under the two FTAs.

As highlighted by Baysan, et al, (2006, p.6), India-Sri Lanka trade was traditionally low (below 1 percent in the 1980s and 1990s) before the signing of ISLFTA. Although this share has increased immediately after the Indian trade reforms reaching a peak in 1996, there was a sharp decline after 1996. However, after signing the agreement it has increased.

The overall trade performance under the ISLFTA is shown in table 3. Sri Lanka's total export to India has increased rapidly after signing the FTA except for the year 2006. Table 3 shows that there has been significant increase in trade in both directions between the two countries. India was Sri Lanka's third largest export destination in 2007 compared with its position of 21st in 1998 and it has become Sri Lanka's number one import source. While Sri Lanka's exports to India as a share of its total exports have increased from 0.8 percent in 1998 to 6.7 percent in 2007, its imports from India as a percentage of its total imports have increased significantly from 9.8 percent to 24.4 percent during the same period. In absolute terms, total trade between the two nations exceeded US\$ 3 billion in 2007 for the first time in history. Sri Lanka's total trade with India is now around 17 percent of its total trade with the world. This indicates that the ISLFTA helped to increase trade between India and Sri Lanka at a faster rate (Department of Commerce, 2008a). Under the FTA, Sri Lankan exporters managed to increase their exports and consumers have been able to consume some imported goods at cheaper prices.

The balance of trade between the two trading partners has always been in favour of India and it has rapidly widened during the post ISLFTA period, having exceeded US\$ 2 billion in 2007 for the first time due to a massive increase in imports from India (52.8 percent in 2007 compared with a 4.5 percent increase in Sri Lankan exports to India) as shown in Table 3. The increase in Indian imports to Sri Lanka will be further accelerated as a result of the phasing out of tariff reduction by Sri Lanka at the end of 2008.

As mentioned before India has become the third largest buyer of Sri Lankan exports and exports from Sri Lanka under concessions granted by the ISLFTA have increased from 15 percent to more than 70 percent of Sri Lanka's total exports. Many observers believe that Sri Lanka has gained from ISLFTA despite the widening negative trade balance between two countries in favour of India.

The increase in Sri Lankan exports can also be explained by using an increase in Indian investment in Sri Lanka during the post ISLFTA period. Sri Lanka has become a major

destination in South Asia for Indian investors and ISLFTA made such export-oriented investment more profitable. India is now fourth biggest investor in Sri Lanka and over 50 percent of Indian joint ventures and subsidiaries in South Asia are now located in Sri Lanka (see for details, Kelegama and Mukherji, 2007). Considering the difficulties attracting FDI from other countries under the current political and security climate in Sri Lanka, the increase in Indian FDI can be considered an economic gain from the ISLFTA.

However, some analysts have raised a number of concerns regarding Sri Lanka's trade between India. Firstly, Sri Lankan exporters do not have the capability or interests of exporting large number of items which were granted duty free concessions by India. For example, Sri Lankan exporters only exported 68 items out of 1,351 duty free access items to India after the first phase of trade liberalisation (Kelegama and Mukherji, 2007).

Secondly, Sri Lankan major export items have been excluded by the negative list and the TRQs. Baysan, et al, (2006, p.3) demonstrate that the ISLFTA agreement "excluded outright many of the major sectors in which the countries had comparative advantage and imposed tariff-rate quotas (meaning the preferential tariff is applied up to a pre-specified quota while the 'Most favoured Nation' (MFN) tariff is applied to the out-of-quota imports) on many others".

Thirdly, as Central Bank of Sri Lanka (2007, p.98) noted, "although Sri Lanka has been accorded such concessions far back in 2003, Sri Lanka still depends on a few export items and lags in export diversification." As highlighted by previous studies, Sri Lanka's exports to India have been highly concentrated around on a limited number of items such as vegetable oil and fats (particularly *vanaspathi*, a hydrogenated vegetable oil similar to ghee) and copper products (see, Baysan, et al, 2006; Kelegama and Mukerji, 2007 and Yatawara, 2007). The story of *vanaspathi* is an interesting case. Palm oil is the main raw material of this product. Indian investors can produce *vanaspathi* in Sri Lanka with a high profit margin by importing palm oil under duty free concessions offered by the Board of Investment rather than producing it India by importing palm oil at 80 percent tariff rate. With this import tariff advantage it has been profitable to import palm oil to produce *vanaspathi* in Sri Lanka and export it to India under zero duty offered by the ISLFTA after meeting the 35 percent ROO. This has given rise to an increase in export of this item significantly. Similarly, it is profitable to import copper scrap to Sri Lanka in order to produce copper products and export to India under concessions. Therefore, these selected items have dominated the Sri Lankan export growth to India. Using a regression analysis Yatawara (2007, p.222) demonstrates that "preferences through the FTA do not have a statistically significant impact on export flows, after controlling for vegetable oils and copper products"

Fourthly, the latest figures related to 2007 shows that there is even a decline in exports of copper products and some other products. Recently, exports of copper and aluminium products, cloves, articles of and clothing accessories and some items of cotton fabrics have also declined from 2006 to 2007. It is important to note here that some export items that enjoyed tariff concession from the beginning under the FTA have now become uncompetitive because of erosion of margin of preferences as a result of trade liberalisation in India in recent years. As the Department of Commerce (2008a) points out in its recent report export values of items such as copper and aluminium products (which enjoyed concessions and performed well previously) have declined from 2006 to 2007. This report further finds that this decline is due to the fact that

the relocated factories based on the incidence of tariff arbitrage find it difficult to survive in the new location as a result of erosion of tariff preferences. Kelegama and Mukherji (2007, p.21) find that para-tariffs such as port charges and non-tariff barriers (NTBs) such as discriminatory sales taxes have also eroded preferences granted to Sri Lanka by India under the ISLFTA.

Finally, the 35 percent ROO under the ISLFTA have been very restrictive and exclusive. Trade has become even more restrictive when considering para-tariffs and other NTBs.

In contrast to the ISLFTA, PSLFTA was implemented recently and it is difficult to evaluate the economic gains qualitatively considering its short period in operation. Thus, we only attempt to highlight important aspects of Sri Lanka-Pakistan trade focussing on the FTA briefly in this section. The main features of Sri Lanka's trade with Pakistan are shown in Table 4. Sri Lanka's trade with Pakistan is relatively small compared with its trade with India. While Pakistan was Sri Lanka's 23rd export destination, it has ranked as the 19th import source for Sri Lanka in 2007. However, overall total trade between the two countries has increased after the FTA (see Table 4). Like in the case of India, the trade balance between Sri Lanka and Pakistan has always been in favour of Pakistan since 1984 mainly because Sri Lanka imports essential food items such as rice, big onions, potatoes and dried fish and raw materials such as cotton. In Sri Lankan rupee terms, the value of Sri Lankan exports to Pakistan has increased by 100 percent from 2005 to 2008. This has been hailed as a success of the PSLFTA by the proponents of PSLFTA.

Despite the success of trade expansion in both directions after implementing the PSLFTA, Sri Lanka has not been able to utilise trade concessions granted under the agreement in important export items such as tea and garments. For example, a TRQ of 10,000 MT was granted by Pakistan for export of tea at duty free level under the FTA. Table 5 demonstrates that the utilisation rate of the tea TRQ has dropped from 30 percent in 2005 to 7 percent in 2007. One of the main reasons for this trend is due to the availability of cheaper smuggled African tea via Afghanistan in the Pakistan market. Similarly, the TRQ facility granted for garments has not been used by Sri Lankan exporters. The only successfully export item under TRQ has been betel leaves and TRQ of this item has been replaced by a MOP of 20 percent in 2007. Sri Lanka has been the main supplier of betel leaves in Pakistan and the value of exports of this item has increased significantly (see Table 5).

Table 3: Status of Sri Lanka's Bilateral Trade with India

Year	Exports (US\$mn)	Imports (US\$mn)	Bilateral trade balance (US\$mn)	SL exports to India as % of its total exports	SL imports from India as a % of its to total imports	Preferential exports to India as a % of total exports to India
1995	30.2	444.9	-414.7	Na	Na	0
1996	41.8	547.7	-505.9	Na	Na	0
1997	42.1	538.8	-496.7	Na	Na	0
1998	35.3	554.8	-513.5	0.8	9.2	0
1999	47.2	511.6	-464.4	1.0	8.5	0
2000	55.7	600.1	-544.4	1.0	8.2	15.5
2001	70.1	601.5	-531.4	1.5	10.1	22.1
2002	168.9	834.7	-665.8	3.6	13.8	67.0
2003	241.1	1076.2	-835.0	4.9	16.5	68.0
2004	385.5	1358.0	-972.5	6.9	17.2	79.0
2005	559.3	1440.4	-881.1	9.1	17.3	74.0
2006	494.1	1822.1	-1328.0	7.2	18.5	>70.0*
2007	516.4	1785.0	-2268.6	6.7	24.4	>70.0*

Source: Department of Commerce (2008a), Kelegama and Mukherji (2007)

* Estimates only based on the Department of Commerce reports.

Table 4: Status of Sri Lanka's Bilateral Trade with Pakistan

Year	Exports (US\$mn)	Imports (US\$mn)	Bilateral trade balance (US\$mn)	SL exports to Pakistan as % of its total exports	SL imports from Pakistan as a % of its total imports	Preferential exports to Pakistan as a % of total exports to Pakistan
2001	24.5	73.2	-48.7	0.61	1.09	-
2002	28.8	65.9	-37.1	0.61	1.09	-
2003	36.1	71.0	-34.9	0.73	1.09	-
2004	39.2	107.9	-68.7	0.70	1.37	-
2005	43.1	115.6	-72.5	0.70	1.39	56%
2006	56.0	140.0	-84.0	0.86	1.50	93%
2007	55.4	179.4	-124.0	0.72	1.57	75%
2008	71.4	198.6	-127.2	Na	Na	Na

Source: Department of Commerce (2008b) and EDB (2008).

Table 5: Export of Tea and Beatle Leaves to Pakistan - 2004 - 2007

Performance of Exports	2004	2005	2006	2007
Tea				
Value of exports (US\$ Mn)	6.36	6.24	8.05	1.59
Volume of exports (MT)	2998	2950	3521	694
Tariff rate quota (MT)	-	10,000	10,000	10,000
Quota utilisation	-	30%	35%	7%
Beatle Leaves				
Value of exports (US\$ Mn)	2.95	2.52	2.58	4.06
Volume of exports (MT)	2848	2651	2609	5425
Tariff rate quota (MT)	-	1,200	1,200	No quota
Quota utilisation		100%	100%	

Source: EDB (2008)

Natural rubber products, coconut and dessicated coconut are the other important export items from Sri Lanka to Pakistan. However, products such as tea, fish, edible fruits, spices, rubber products, ceramic and precious stones in which Sri Lanka has comparative advantage and are eligible for concessions granted by Pakistan are not performing well. In other words, Sri Lanka has not been able to capture the full potential in these areas. Similar to Sri Lanka-India trade, 80 percent of Sri Lankan exports to Pakistan still have been confined to a limited number of products.

In contrast to the importance of Indian investment in Sri Lanka, Pakistan investment is not playing an important role in Sri Lanka. Even after the signing of PSLFTA, there is no significant increase in Pakistani investment in Sri Lanka.

The above discussion on economic gains from ISLFTA and PSLFTA demonstrate that Sri Lanka has managed to increase its trade flows with two countries after implementing two FTAs. However, a detailed analysis of performance of different export items of Sri Lanka indicate that trade between Sri Lanka and the two neighbouring countries have been restricted by negative lists. Sri Lanka is continuing talks with both countries to extend the two FTAs to CEPAs. Under CEPAs, Sri Lanka expects a deeper and wider trade liberalisation between India and Pakistan.

To further examine the potential economic benefits of bilateral trade liberalisations between India and Sri Lanka and between Pakistan and Sri Lanka, we use the GTAP model to simulate scenarios of full trade liberalizations between the two pairs.

The GTAP model (see Hertel 1997 for the model's structure) has been one of the most used quantitative economic tools in evaluating FTAs or RTAs in recent years. In this section we used the GTAP model to examine the effects of full trade liberalisation under two FTAs without having negative lists. While there are a number of studies which have already employed the GTAP model to examine the effects of ISLFTA in the past (see Siriwardane, 2004; Bandara and

Yu, 2006; and Perera, 2007), no study has so far undertaken an evaluation of the effects of PSLFTA using GTAP (at least to our knowledge). As policy experiments, full trade liberalisation scenarios under both FTAs provide the opportunity to examine the potential effects of further liberalizations under the two FTAs. Results from these simulations are used to complement the ex-post analysis provided above.

The latest GTAP version 7 database (see www.gtap.org for documentations of the GTAP 7 database), which has 2004 as its base year, is used as the starting point or base case for individually simulating the two full trade liberalization scenarios. In other words, full trade liberalizations between the two pairs (ISLFTA and PSLFTA) are simulated by cutting all the bilateral trade barriers between India and Sri Lanka and those between Pakistan and Sri Lanka (as embodied in the 2004 base case) to zeros. Also, any changes in bilateral trade and the resulted welfare changes are measured against the 2004 base. Results from these simulations are used to complement the ex-post analysis provided above.

We first report the simulation results related to the full trade liberalization scenario concerning India and Sri Lanka (ISLFTA). The simulated changes in bilateral trade are presented in Table 6. Measured in world market prices, India's exports to Sri Lanka (US\$ 1,386 mil) far exceeded Sri Lanka's exports to India (US\$ 454 mil) in 2004. Fully removing the remaining trade barriers against each other in 2004, however, would lead to a more balanced bilateral trade pattern between the two countries, with India's bilateral exports reaching US\$ 2,085 million and Sri Lanka's bilateral exports nearly tripling to US\$1304 million. Sri Lanka's expected export expansion would come from both agricultural sectors and manufacturing. In contrast, India's export expansion would be more modest and largely concentrated in manufacturing.

These changes in bilateral trade generally would lead to very modest welfare effects for both countries (see Table 7). In the case of India, a small and negative allocation efficiency effect is more than offset by a small and positive terms of trade effect. For Sri Lanka, perhaps reflecting the restrictive nature of the current negative list maintained by India, a more significant welfare gain would be expected at US\$ 164 million, including a terms of trade gain of US\$ 140 million.

Next we turn to simulated results for the full trade liberalization between Pakistan and Sri Lanka. The 2004 database reports very small trade flows in both directions (US\$ 173 million exported by Pakistan and 46 million by Sri Lanka). Full bilateral trade liberalization would lead to substantial relative increases in exports from both directions, although the absolute values of such flows remain modest. Moreover, the results show that Sri Lanka would benefit more significantly from a full FTA as its exports would rise from US\$ 46 million to more than US\$743 million, while export expansion from Pakistan would be less dramatic (rising from US\$173 million to US\$ 254 million, most of which would be due to increase of rice exports). However, the simulated increase in exports from Sri Lanka is almost entirely due to increased exports of extraction. The trade-weighted tariff rate in the extraction sector imposed by Pakistan is 116 percent. Controlling for the increase in the extraction sector, simulated increase in Sri Lanka's exports to Pakistan would actually be lower than that from Pakistan to Sri Lanka.

Consistent with the above discussion, a full FTA between Pakistan and Sri Lanka would only benefit Pakistan marginally, with the main source of welfare gains being efficiency improvement.

In the case of Sri Lanka, the bulk of the simulated welfare gains of US\$ 290 million is terms of trade improvement.

In summary, full trade liberalizations between both Sri Lanka and India and Sri Lanka and Pakistan seem to be able to trigger additional trade flows in both cases, with Sri Lanka's exports to both India and Pakistan increasing more than its counterparts in both FTAs. However, the absolute sizes of the simulated changes in trade flows in both FTAs remain quite modest. As such, small welfare gains would be expected from such deals.

Table 6: Values of bilateral exports at world market prices between India and Sri Lanka and between Pakistan and Sri Lanka: 2004 versus simulated full FTAs (million US dollars)

Sector	India-Sri Lanka		Sri Lanka-India			Pakistan-Sri Lanka		Sri Lanka-Pakistan	
	Base	ISLFTA	Base	ISLFTA		Base	PSLFTA	Base	PSLFTA
Paddy rice	1.1	6.6	0	0		0	0.6	0	0
Wheat	42	41.9	0	0		0	0	0	0
Cereal grains, nec	16.2	17.1	0	0		0	0	0	0
Vegetables, fruits & nuts	35.6	72.4	11.8	55.7		6.3	15.3	3.2	5.1
Oil seeds	1	6.1	0.6	1.1		0.1	0.3	9.3	12.8
Sugar cane	0	0	0	0		0	0	0	0
Plantation-based fibers	0	0	0.2	0.4		0.1	0.1	0.3	0.4
Crops, nec	23.6	75.3	24.9	149.7		1.7	4.5	7.1	21.9
Meat cattle	0.3	1.1	0.2	2.9		0	0	0	0
Dairy products	0.6	1.8	0	0.1		0	0	0	0
Processed rice	55.2	120.5	0	0		21.4	69.1	0	0
Vegetable oil & fats	26.5	50	21.7	167.8		0	0.1	0.4	2.5
Sugar	10.6	29.6	0.1	0.2		0.5	1.8	0	0
Other food processing	13.7	21.7	1.9	7.6		8.2	11.1	0.2	0.4
Wool	0	0	0	0		0	0	0	0
Beverages 7 tobacco	1	4.5	0.1	0.7		0	0	0	0
Extraction	6.5	22	2.9	8.6		0.1	0.2	2.8	648
Textiles & clothing	155.2	163.4	9.9	25.4		113.4	111.9	1.3	3.4
Light manufacturing	273.6	433.4	45.4	112.7		1.3	2.9	5.4	23.3
Heavy manufacturing	708.6	1001.9	264.3	706.6		19.2	35.3	14.2	23.7
Utilities	0.1	0.1	0.5	0.4		0	0	0	0
Transport & Communication	10.7	11.4	64.2	58.9		0.3	0.3	1.3	1.2
Other services	4	4.3	5.6	5.1		0.6	0.6	0.9	0.8
Total	1386.1	2085.2	454.2	1303.9		173.2	254	46.4	743.5
changes in total		699.1		849.7			80.8		697.1

Source: GTAP version 7 database and simulation results.

Table 7: The Welfare Effects of Full Trade Liberalisations

	Full FTA between India and Sri Lanka			Full FTA between Pakistan and Sri Lanka		
Countries/regions	Allocation efficiency effects	Terms of trade effects	Total welfare effects	Allocation efficiency effects	Terms of trade effects	Total welfare effects
Australian	-0.7	-2.6	-4.5	-0.5	-10.7	-12.7
New Zealand	0	0.5	0.4	0.1	1.5	1.4
Rest of Oceania	0	0.2	0.1	-0.1	-0.9	-1.1
China	12.7	-7.1	2.6	14.6	13.3	19.5
Hong Kong	0	3.3	2.9	0	6.7	5.5
Japan	-2.4	-22.9	-25.5	-2.3	11.8	2.7
Korean	-0.9	-8.4	-8.7	0.6	15.3	12.7
Taiwan	-0.4	-5.8	-5.3	-0.1	4.1	3.8
Rest East Asia	0.1	0.5	0.5	0.2	0.6	0.5
SE Asia	-1.7	-26	-25.2	1.3	2.1	1.3
Bangladesh	0	0.3	0.4	0	0.8	0.9
India	-29.1	35.4	12.8	2.4	5.5	6.5
Pakistan	-1.3	-4.6	-7.5	183	-98.3	90.4
Sri Lanka	-5.8	139.7	164	-9.2	251	290.4
Rest South Asia	-1.7	-2.8	-5.1	-1.2	-0.4	-2
USA	-14.7	-39.7	-74	-12.4	13.3	-6.9
Canada	-1.1	-0.8	-2.6	-1	-9.6	-12.6
Rest North America	-2.6	2.2	-1	-8	-5.8	-14.8
Latin American	-1.7	-3.2	-5.4	0.3	-10.4	-13.2
EU_25	-50.1	-59	-118.7	-37.1	17	-35.6
Mideast & N Africa	-2.7	-0.4	-3.7	9.6	-134.4	-121
Sub-Sahara Africa	-1.6	0.8	-1	-2.4	-23.4	-26.2
Rest of World	-14.6	-0.8	-17.2	-9.6	-52.8	-66
World	-120.4	-1.1	-121.8	128.3	-3.8	123.8

Note: numbers are in millions of US dollars.

Source: simulation results.

6. Political and Military Gains from ISLFTA and PSLFTA

In addition to the economic benefits of two FTAs, Sri Lanka has benefited from them politically and militarily. Both FTAs have created spillover effects or political externalities in favour of Sri Lanka. After gaining independence from the British in 1948, Sri Lanka, as a small neighbour, had to maintain strategic political relationships with its two big neighbours (India and Pakistan) with nuclear power. Until the 1980s it had a normal cordial relationship between both countries. From independence Sri Lanka had to deal with India closely than Pakistan mainly because of the ethnic link between the Sri Lankan minority Tamils (around 18 percent of the total population) and the Tamils of Tamil Nadu (where more than 60 millions Tamils live) in India. This ethnic link has played an important role in the Sri Lanka-India relationship. Before it signed the

ISLFTA with India in 1998, Sri Lanka signed two political treaties with India. It signed the first political treaty with India in 1964, known as the *Srima-Shastri* pact to solve the citizenship problem of the hill country Tamils (known as Indian or “estate” Tamils, 6 percent of the total population) who were bought from South India by the British to work in the plantations (mainly in tea estates) during the 19th century. This Tamil group has been separately recognised from the Sri Lankan Tamils (around 12 percent of the total population) who live in the North and Eastern part of the island. The latter group have been living in the island for centuries and the Tamil Tigers have been fighting since the 1980s to create a separate state known as “Tamil Eelam” or Tamil motherland for the later group. As Sarvanathan (2000, p.1158) notes, the 1964 pact was never fully implemented although it attempted to address the issues of estate Tamils. In the 1960s and 1970s this pact dominated political diplomacy between India and Sri Lanka.

Sri Lanka signed the second political treaty with India in 1987 known as the “Indo-Sri Lanka Peace Accord” when it was under tremendous political pressure from its big neighbour in relation to the issue of Sri Lankan Tamils or the Tamil minority. During the 1960s and 1970s Sri Lanka had somewhat friendly diplomatic relationship as a result of the close link between two political dynasties in two countries (under the leadership of Mrs Srimavo Bandaranayake in Sri Lanka and Mrs Indira Gandhi in India). In Sri Lanka, the pro-western Jayawardane government came to power in 1977 and it immediately implemented open economic policies. This government diplomatic relationship with India was somewhat tense particularly during the well-known “ethnic riots” in July 1983. Since then, the political relationship between India and Sri Lanka was not healthy in the 1980s and the early 1990s. The Tamil militant groups set up training camps in India and they were allegedly provided with financial support by the Tamil Nadu government in the early 1980s. Although Sri Lanka wanted India to take measures against these militant groups, India was reluctant to take measures due to the Tamil Nadu factor and other geo-political reasons. The 1983 riots created a huge refugee problem in India and the Indian government was sympathetic toward the Sri Lankan Tamils. Immediately after the ethnic riots in 1983 there was an anti-Sri Lankan sentiment in the state of Tamil Nadu. As has always been the case, there was a strong pressure on the Indian central government to be involved in the Sri Lankan conflict.

When the Sri Lankan army nearly crushed the LTTE in 1987, India got involved in the conflict directly even breaching international laws by entering the Sri Lankan air space and dropping food items in the Jaffna Peninsula. Eventually, the Indian government forced the Sri Lankan government and the LTTE to enter into the Indo-Lanka Peace Accord in 1987 and sent more than 100,000 troops as the Indian Peace Keeping Force (IPKF). This accord was hailed as a successful solution to the ethnic problem in Sri Lanka at the time and the LTTE leader symbolically handed over weapons to the Sri Lankan Army Commander. However, in subsequent years, the accord failed and the LTTE started a war against the IPKF in the North. Furthermore, the south of the island was agitated by the presence of IPKF. This led to an unusual informal unity between the Sri Lankan government, northern separatists (LTTE) and the Southern rebellion movement known as the *Janatha Vimukthi Peramuna* (JVP) against the Indian military presence in the Island. As a result, the Sri Lankan government requested the Indian government to withdraw the IPKF and India was happy to withdraw its troops in 1991 since the casualties were also mounting. The memory of Indian intervention in the late 1980s created mistrust between India and Sri Lanka. The political relationships were also somewhat

tense in the early 1990s. After the withdrawal of IPKF the Sri Lankan government began the war against the LTTE since its peace talks with the LTTE collapsed in 1991. After another episode of war, the Sri Lankan government entered into another rounds of peace talks in 1995. These efforts collapsed within three months and the LTTE declared the war again in 1995 by shooting down two aircrafts and destroying a navy ship. The war intensified in the late 1990s. In the meantime, India was also under pressure from the International community as a result of the nuclear test in 1998.

Against the above background of tense political relationship between Sri Lanka and India and the internal conflict, Sri Lanka had to take diplomatic measures to at least neutralise Indian pressure on the war front and obtain military assistance if possible. It had to find ways to protect the security of the country and rebuild the trust. The negotiations and formulation of the ISLFTA provided opportunities for both countries to develop healthy diplomatic relationships and rebuild the trust between leaderships. Sarvananthan, (2000, p.1158) clearly observes that political reasons forced two countries to formalise ISLFTA hastily as follows:

“It seems that the FTA was a hastily concluded treaty, because India was perhaps feeling the pinch of American economic sanctions in the aftermath of nuclear tests in May 1998 and therefore was looking for alternative export markets, and Sri Lanka was perhaps pushed into the treaty to be in the good books of India due to politico-military considerations connected to the protracted civil war in Sri Lanka”,

Recently, Kelegama and Mukherji (2007, p.2) have noted that “politics was ultimately the major player in the move towards free trade” and political forces were instrumental in the signing of ISLFTA among other factors.

From the above discussion it is clear that the ISLFTA assisted Sri Lanka to prevent direct Indian intervention and other threats from the late 1990s. Sri Lanka managed to rebuild the trust and gain confidence from the Indian government. The Indian response to the current Sri Lankan military onslaught against the LTTE is an excellent example of how Sri Lanka has benefited politically and militarily from the ISLFTA. In contrast to the 1980s situation, Sri Lanka has been continuously communicating at leaders, ministerial and military levels regarding the on going current war against the LTTE. The Indian central government is currently under enormous pressure from Tamil Nadu politicians as well as the Tamil community in general including lawyers, student movements and artists to directly intervene in the Sri Lankan war. They want India to directly intervene in Sri Lanka militarily to help the Tamil minority on humanitarian grounds. This is the most sensitive period in India considering the general elections to be held in April and May. The major political parties in India are under pressure from Tamil Nadu politicians and they use the Sri Lankan Tamil issue as a bargaining point specially when an elections around the corner. So far Sri Lanka has managed to avoid direct Indian intervention. The Indian central government led by the Congress Party is continuously in touch with Sri Lankan leaders. The ISLFTA has been one main factor among other political and military reasons such as LTTE's alleged involvement in the assassination of the former Prime Minister Rajive Gandhi, the changing world opinion against terrorism after the 9/11 attack, the recent terrorist attack in Mumbai and the unpleasant experience of the previous Indian intervention in Sri Lanka.

The above discussion demonstrates that the ISLFTA helped Sri Lanka to be in India's good book and to avoid India's direct military intervention during the current war against the LTTE in contrast to the situation in the late 1980s. This political benefit is much larger than the economic benefit of ISFTA. Kelegama and Mukherji (2007, p.37). point out, "finally, the economic benefits of free trade can and do override political problems; the ILBFTA has done much to clear the acrimonious political atmosphere that marked Indo-Lanka relation during the 1980s" Recently CUT International has expressed similar sentiment stating that "the India – Sri Lanka FTA has proved to be a harbinger of peace between the two countries". It further notes that "the relationship between New Delhi and Colombo has now ceased to be overly political, and more cultural and economic, thanks to the phenomenal success of the FTA" (CUTS International, 2008, p.3).

The ISLFTA not only helped to bring political peace between Sri Lanka and India, but it also helped to remove Sri Lankan antagonism towards Indian imports and investment. In the late 1980s, there was a strong anti-Indian feeling among the Sinhalese majority in the South of the island. There were Sinhalese movements advocating for the boycotting of Indian products and Indian FDI. With the signing of the ISLFTA, these anti-Indian sentiments have been evaporated. As Weerakoon and Thennekoon (2008, p.139) point out "while at times tense political relationships with India have discouraged more active Indian involvement in the Sri Lankan economy, the marked improvement in bilateral relations since the late 1990s – reflected in the signing of the FTA – has seen Indian investment picking up sharply to become the fourth largest investor in Sri Lanka".

While ISLFTA assisted to neutralise the threat of Indian military intervention in Sri Lanka, PSLFTA helped Sri Lanka to fight against the LTTE and enhance the security in the country. Many western countries refused to sell arms to Sri Lanka during its war against the LTTE since the 1980s. While India has always been under pressure from Tamil Nadu not to sell arms to its small neighbour, the western countries have been under pressure from international human right organisations and the Tamil Diaspora not to sell arms to the Sri Lankan government on the ground of alleged human rights violations and discrimination against the Tamil minority. Therefore, only a handful of countries have been selling arms to Sri Lanka including Israel, China, Pakistan and Russia. Pakistan has always been a good political ally of Sri Lanka in terms of providing much needed arms to fight against the LTTE and other diplomatic and social fronts.

Pakistan has become a main source of military assistance to Sri Lanka. There are a number of examples to demonstrate how Pakistan helped Sri Lanka when it needed urgent military assistance. In 2001 the Sri Lankan military was facing a huge set back and the LTTE was threatening to recapture Jaffna (the capital of the Tamil heartland which was captured by the Sri Lankan army in 1996) by trapping nearly 40,000 Sri Lankan soldiers in the Jaffna Peninsula. When the Sri Lanka government requested military assistance from India, it only offered help to evacuate trapped soldiers from Jaffna rather than helping the Sri Lankan government militarily. Under this emergency situation, Pakistan offered its fullest support by providing much needed sophisticated weapons and ammunitions to the Sri Lankan army within a week or so. Sri Lankan forces avoided the military humiliation in 2001 and prevented the recapture of Jaffna by the LTTE. This was the turning point of twenty five year war in Sri Lanka. The PSLFTA helped

Sri Lanka to cement this friendship and enhance its links with Pakistan. Pakistan is also helping Sri Lanka's current war effort to fight against the LTTE by selling arms and keeping direct military contacts. It has come to rescue Sri Lanka when it has been isolated and constant political pressure from powerful western countries. In turn, Sri Lanka is maintaining a friendly relationship with Pakistan. The recent visit of the Sri Lankan cricket team to Pakistan, which was marred by the terrorist attack, is an example of how Sri Lanka reciprocates in its friendship as all other cricketing nations were reluctant to tour Pakistan.

The Sri Lankan FTAs with India and Pakistan can also be considered as strategic in terms of Indian and Pakistani investment in Sri Lanka. Because of the tense political relations between Pakistan and India, their official trade is very small although unofficial trade is very large. Therefore, both Pakistan and Indian investors can penetrate the two countries' markets via Sri Lanka. Sri Lanka can be a strategic location for these two countries' investors (see Yatawara, 2007).

7. Conclusion

Many bilateral and plurilateral trading agreements have been concluded between countries explicitly or implicitly as a result of political needs of governments rather than purely based on economic benefits of such agreements. Sri Lankan bilateral trade agreements with India and Pakistan are excellent examples. It is clear from our analysis that Sri Lanka indirectly gained non-economic benefits from two FTAs with India and Pakistan. These two agreements helped Sri Lanka to successfully execute the war against the LTTE by neutralising India on the one hand and getting military assistance from Pakistan on the other hand. Even though these political objectives have not explicitly been outlined in ISLFTA and PSLFTA, Sri Lanka has certainly been benefited from these agreements as positive externalities. Our findings support the previous research on this topic. Our economic analysis also demonstrates that these agreements have brought some economic benefits to Sri Lanka, particular from the ISLFTA.

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