

**A STUDY OF DETERMINANTS OF
TRADE IMBALANCE
BETWEEN INDIA AND SRI LANKA : 2000-2007**

Bo

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Declaration Statement

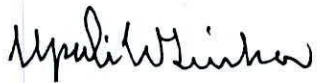
The work described in this thesis was carried out by me under the supervision of Prof. Upali Wickramasinghe, Professor of Economics, Department of Economics, University of Sri Jayawardenapura and a report on this has not been submitted in whole or in part to any University or any other institution for another Degree / Diploma.



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Supervisor's Declaration Statement

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ABSTRACT

One of the interesting developments in the world economy during the past one and half decade has been the phenomenal growth of regional trading agreements and the significant increase in world trade emerging from these arrangements. Regionalism has become so widespread that at present over 60 per cent of world trade is believed to be taking place among the members of trading blocks.

Indo-Lanka Free Trade Agreement (ILFTA) which was fully implemented by March 2008 has resulted in almost fivefold increase in bilateral trade since 2000 to reach US\$ 3.2 billion in 2007 from US\$ 672 million in 2000. The timeframe of tariff phase out between the two countries are now over. The ILFTA implementation period for India was from 2000 to 2003, whereas for Sri Lanka, the implantation period was eight years, from 2000 to 2008.

India has taken a lead over Japan in the post-ILFTA period in terms of its share in Sri Lanka's global imports. In 1999, India's share was 8.5 in Sri Lanka's import and India was the second largest after Japan. But in 2000, India achieved a share of over 16.2 in Sri Lanka's import and became the largest source of imports. Prior to the ILFTA, bilateral trade between India and Sri Lanka grew by just 10 per cent per annum in a seven years period, from 1993-1999. However, ILFTA realty accelerated the trade flow between the two countries and this grew to over 27 per cent in the post-ILFTA period.

Though there was a significant increase in bilateral trade between India and Sri Lanka after implementation ILFTA, much attention has been focused on the chronic trade imbalance between the two countries as Sri Lanka has been having persistent trade imbalance with India under the bilateral trading environment. This has resulted in the belief that benefits created by bilateral trade between India and Sri Lanka could not be fully realized by the Sri Lankan economy in a balanced manner.

Therefore, an attempt is made in the present study to analyse structure, growth and performance of Indo-Lanka bilateral trade and identify the determinants that led to a growing trade imbalance. The study finds that increase in import demand for Indian goods at a faster rate, insufficient supply capacity of Sri Lanka, lack of trade complementarities between two countries as major factors contributing to the unfavorable trading situation for Sri Lanka. Finally, the study had made recommendations on how to take the two economies forward, towards great integration and sharing the benefits of bilateral trade between the two countries in a more balanced manner.

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CHAPTER 01

INTRODUCTION

1.1 Introduction

Trade between India & Sri Lanka has been taking place for so many years, dating back to several centuries. Sri Lanka is India's largest trading partner in the SAARC region. Today, India has become the largest source of import and the third largest export destination for Sri Lanka, next to USA & UK according to the annual report of Central Bank for 2007. In particular, bilateral trade and investment links of both countries have deepened and widened considerably over the last eight years. The signing of Indo-Lanka Free Trade Agreement (ILFTA) in December 1998, marked a turning point in economic relations between the two countries according to the detailed data presented in this study. ILFTA is considered to be a shining example of economic cooperation in South Asia by many researchers.

Both countries have exchanged duty free concessions and preferential duty concessions under the South Asian Preferential Trade Agreement (SAPTA) of 1998. SAPTA's slow progress shifted the focus to a bilateral agreement, Indo-Lanka Free Trade Agreement (ILFTA) which came into force in 2000 as a fast track for promoting bilateral trade between the two countries which, has completed eight years of operation. With the initial success of ILFTA and growth in service trade, the scope of the agreement is now being extended to Comprehensive Economic Partnership Agreement (CEPA). Both governments now have finalized negotiations on CEPA which is expected to sustain and build on the momentum generated by ILFTA taking the two economies beyond trade in goods.

Since independence, Sri Lanka has been having a persistent adverse trade balance with India in bilateral trade. Supply capability of the Sri Lankan economy does not seem to match well with India's demand structure of imports. Sri Lanka's emerging manufacturing structure was "competitive" rather than "complementary" to India's industrial sector and whatever Sri Lanka could produce, India could also produce more cheaply (Kelagama, 1997). Sri Lanka's adverse trade balance with India was US \$ 2229.4 million in 2007, approximated to 60% of her adverse trade balance with the entire world, totaling US \$ 3727.4 million (Central Bank Annual Report, 2007). An attempt is made in the present study to analyze the structure and growth of Indo-Sri Lanka bilateral trade and identify the determinants of trade imbalance between the two countries.

1.2 Problem Identification

1.2.1 Problems Statement

Despite preferential and bilateral trade agreements, which are essentially designed to promote fair competition & equitable benefits, persistent trade imbalance between India and Sri Lanka does not seem to be narrowing down.

1.2.2 Background of the problem

Although the bilateral trade gap in a more integrated world may not be such a useful measure to point out the health of the economy under the multilateral trading environment, it is important, however, to identify the determinants of trade imbalance of the two countries under the bilateral trade agreement with the exchange of

preferential and duty free concessions as benefits of bilateral trade are to be shared by both countries.

Bilateral trade between India & Sri Lanka has grown rapidly in recent years. India is now the largest trading partner in South Asia and the largest supplier of imports to Sri Lanka, ahead of Japan in 1995, followed by Singapore, Hong Kong. India has become the third largest export destination of Sri Lanka. Table 1.1 presents the bilateral trade figures between India & Sri Lanka from 2000 to 2007.

Table 1.1

Bilateral Trade between India and Sri Lanka, 2000-2007

USD Mn

Year	Imports from India	Exports to India	Sri Lanka's trade balance	EXIM Ratio SL imports/SL Exports
2000	600.1	55.7	-544.5	10.3:1
2001	601.5	70.1	-531.4	8.4:1
2002	834.6	168.7	-665.9	4.9:1
2003	1076.2	241.1	-835.0	4.4:1
2004	1358.0	385.5	-972.5	3.5:1
2005	1439.5	589.1	-880.5	2.5:1
2006	1805.2	486.5	-1315.7	3.6:1
2007	2744.3	514.9	-2229.4	5.3:1

Source: Central Bank of Sri Lanka, Annual Report – 2008

While bilateral economic ties between India & Sri Lanka are robust, they have been characterized from its inception by a growing bilateral trade imbalance. Initially, the balance in India's favor was small but after signing of Indo – Sri Lanka trade agreement in 1998, it has grown substantially and now constitutes the largest single bilateral trade deficit of Sri Lanka.