

# Considerations for formulating a trade policy for Sri Lanka

*Presentation to the "Peoples' Commission for National Policy on International Trade" on 18 May 2017 by Rohan Samarajiva<sup>1</sup>*

We must look to the future, not the past. We must be realistic about where we are at present and what our potential is. We must always take into consideration our external environment, especially the actions of competitively positioned countries. We must give priority to the broad public and national interest, not those of narrow interest groups. My brief comments are organized around the above principles.

1.0 The future is Asia. Most models of international trade assume that greater trade will occur with nearby countries than with those which are far distant.<sup>2</sup> At present, Sri Lanka's goods exports violate this assumption, going primarily to the US and Europe.<sup>3</sup> This was also the case with Mode 2<sup>4</sup> service exports in tourism until recently. But things have changed in tourism service exports, with India and China becoming the principal sources. We must make active efforts to reorient goods exports to Asia because Asia is where the highest growth is occurring. With turbulence in trade policy caused by the failure of the Doha Round of World Trade Organization (WTO) negotiations and the US withdrawal from the Trans Pacific Partnership (TPP), we must focus on plurilateral agreements within Asia, giving primacy to the emerging single market of ASEAN, India and China. Joining some form of ASEAN plus agreement such as the Regional Comprehensive Economic Partnership (RCEP) would be optimal. A comprehensive goods, service and investment agreement among BIMSTEC countries would also be desirable. But bilateral agreements with willing countries are a necessary step for a small economy such as ours to get to the negotiating table where these plurilateral agreements are reached. But the immediate impact of completing the ongoing negotiations will be substantial. Firms located in

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<sup>1</sup> Please see Annex 1 for a biographical summary and selected trade-related publications.

<sup>2</sup> The gravity equation of international trade states that bilateral trade between two countries is proportional to size, measured by GDP, and inversely proportional to the geographic distance between them -- Chaney, T. (2013, August). The Gravity Equation in International Trade: An Explanation, *NBER Working Paper No. 19285*. <http://www.nber.org/papers/w19285>

<sup>3</sup> In the case of imports, China was the largest source (21.7 percent), followed by India (19.7 percent), in 2016. India was the largest source before 2016: Sirimanne, B. (2017 May 14). China emerges as Sri Lanka's main import source replacing India, *Sunday Times*. <http://www.sundaytimes.lk/170514/business-times/china-emerges-as-sri-lankas-main-import-source-replacing-india-239808.html>

<sup>4</sup> For explanation of the four modes of services trade, see: [https://www.wto.org/english/tratop\\_e/serv\\_e/cbt\\_course\\_e/c1s3p1\\_e.htm](https://www.wto.org/english/tratop_e/serv_e/cbt_course_e/c1s3p1_e.htm)

Sri Lanka which satisfy the preferential rules of origin<sup>5</sup> stipulated in the various agreements will have access to a market of 3 billion people. These firms may be fully owned by Sri Lankan citizens, joint ventures, or fully owned by foreign investors.<sup>6</sup>

1.1 Both India and Vietnam have entered into multiple bilateral agreements,<sup>7</sup> which is yielding them good results, but also giving rise to the “noodle bowl effect.”<sup>8</sup> But these complications are likely to be reduced when they join RCEP or a similar plurilateral arrangement. The good results are illustrated by Table 1, which compares Sri Lanka’s and Vietnam’s investment and trade performance. The increase in FDI was in the same range (7 times and 9 times); but Vietnam increased exports by 9.5 times versus Sri Lanka’s paltry doubling.

**Table 1: Vietnam’s and Sri Lanka’s investment and trade performance 2000-14, compared**

	Vietnam (2000)	Vietnam (2014)	2014 amt as multiple of 2000 amt	Sri Lanka (2000)	Sri Lanka (2014)	2014 amt as multiple of 2000 amt
FDI (USD millions)	1,298	9,200	7.1	173	1,616	9.3
Exports (USD billions)	17	161	9.5	5.5	11.3	2.1

Source: Board of Investment of Sri Lanka

2.0 Trade policy in the 21<sup>st</sup> Century is not a zero-sum game where scores are kept in terms of positive/negative trade balances. In the context of global production networks (GPNs), components of end products (including services) cross and re-cross borders. Here is what the economists at the Central Bank of Sri Lanka say about our failures to catch this wave: “Regional competitors, particularly East and South East Asian countries such as China, Taiwan, South Korea, Thailand, Malaysia, Vietnam and Indonesia, have dramatically increased their manufacturing exports through global production networks. India, which traditionally focused on labour intensive manufacturing exports, has integrated successfully with global production networks producing technology intensive parts and components for data processing machines,

<sup>5</sup> Preferential rules of origin are applied by countries that offer certain trade partners zero-duty or reduced-duty access for their imports as a means of determining the eligibility of products to receive such preferential access. -- Brenton, P. (n.d.). Preferential rules of origin,

<http://siteresources.worldbank.org/INTRANETTRADE/Resources/C8.pdf>

<sup>6</sup> An example of investments being attracted by market access (in this case GSP+), is the Hero Bicycles investment of USD 20 million in BSH Ventures, a bicycle manufacturer located in Biyagama: Sirimanne, S. (2016 April 4). Hero Cycles to make Sri Lanka bicycle hub in South Asia, *Ceylon Daily News*,

<http://dailynews.lk/2016/04/04/business/78194>

<sup>7</sup> India has entered into agreements with Finland, SAARC (multiple, inactive), Singapore, Malaysia, multiple countries in Africa, Chile, Afghanistan, ASEAN, Bhutan, Japan, Korea, MERCOSUR, Nepal, Sri Lanka, WTO (GATS, GATT). Vietnam has directly entered into agreements with Chile, Japan and South Korea and through ASEAN with Australia, New Zealand, India, Japan, China, and South Korea.

<sup>8</sup> <http://www.unescap.org/resources/asia-pacific-noodle-bowl-trade-agreements>

electrical machinery and semiconductor devices. Conversely, only a fraction of Sri Lanka's manufacturing exports moved through global production networks during this period."<sup>9</sup>

- 2.1 GPNs are highly efficient, but they are vulnerable to disruption, as evidenced by worldwide problems caused by the Bangkok floods of 2011.<sup>10</sup> Therefore, firms active in GPNs pay special attention to managing risks, both natural and human in origin. Trade agreements that cover services trade including clear provisions regarding Mode 4 movement of natural persons are important in this regard.
- 2.2 Sri Lanka's more efficient logistics and port facilities (relative to South Asia, but not South East Asia)<sup>11</sup> may give us an edge in participation in GPNs. That this has not materialized indicates that the legal and regulatory risks are washing out the logistics advantages.
- 3.0 Services are becoming increasingly important in the economy as a whole and within international economic relations. The first trade agreement to include enforceable provisions on services was the Canada-US Free Trade Agreement of 1987. Sri Lanka is party to the General Agreement on Trade in Services (GATS) which came into effect in 1995. Now, every trade agreement includes services. Of the Sri Lankan labor force, 46.5 percent are employed in the service sector, in activities ranging from plucking coconuts to retail trade to software work. This is considerably larger than the 27.1 employed in agriculture and the 26.4 employed in manufacturing.<sup>12</sup> Mode 4 service exports in the form of labor exports yielded earnings (remittances) of USD 7.2 billion in 2016. While labor exports slowed, earnings grew by 3.7 percent in 2016.<sup>13</sup> Earnings from exports of services recorded a growth of 11.6 per cent to USD 7.1 billion in 2016. About half came from tourism service exports (Mode 2), which yielded USD 3.5 billion in earnings in 2016, an 18 percent growth over 2015. Earnings from telecommunications, computer and information services increased from USD 805 million in 2015 to USD 858 million in 2016. The combined service-export earnings were larger than the USD 10.3 billion earned from the export of goods. Services are critical inputs for all economic processes, including goods exports. For the overall efficiency of the economy and for improved competitiveness in exports, it is important to enhance competition in service industries, which is best done by opening them to international competition.
  - 3.1 Because service trade across borders requires movement of juridical (Mode 3) and natural persons (Mode 4), there is an unjustified opposition to services trade in general, and services agreements in particular. The usual harms associated with protectionism result when domestic suppliers use political pressure to inhibit competition and extract rents in service industries. When protectionism is extended to services that are critical inputs to other economic processes, the overall economy suffers.
  - 3.2 The positive-list method used in services-trade agreements allows for a highly calibrated opening up of sectors and Mode 4 commitments. Unlike in goods agreements, a sector

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<sup>9</sup> Central Bank of Sri Lanka (2017). *Annual Report 2016*. Colombo: CBSL, p. 29.

<sup>10</sup> E.g., Fuller, T. (2011 November 6). Thailand flooding cripples hard-drive suppliers, *New York Times*, <http://www.nytimes.com/2011/11/07/business/global/07iht-floods07.html>

<sup>11</sup> Dappe, M.H. & Suarez-Aleman, A. (2017). *Competitiveness of South Asia's ports: A comprehensive assessment of performance, drivers and costs*. Washington DC: World Bank.

<sup>12</sup> *Sri Lanka Labour Force Survey, Annual Bulletin 2016*.

<sup>13</sup> Central Bank of Sri Lanka (2017). *Annual Report 2016*. Colombo: CBSL, p. 12.

is brought within the scope of the agreement only when it is specifically included and schedules of commitments are offered. Sri Lanka made commitments only in tourism and travel-related services, telecommunication services, and financial services in the case of the only services-trade agreement it is party to, the GATS.<sup>14</sup> They too were very conservative and even so, not fully adhered to.<sup>15</sup> Usually, Mode 4 provisions in services-trade agreements affect only professionals, senior managers, etc. Quantitative limits, minimum-salary requirements, etc. can be imposed.<sup>16</sup> This enables government to assuage the protectionist concerns of organized groups even to the detriment of the overall economy and the interests of the consumer.

3.3 However, given the enormous importance of Mode 4 service exports in the form of expatriate workers traveling to West Asia and elsewhere, we should consider building in safeguards for even non-professionals in the trade agreements that we negotiate. With Sri Lanka now facing labor shortages in critical sectors such as construction,<sup>17</sup> it is time to consider well-designed labor contracts articulated with improved enforcement of immigration laws, as indicated by the proposal to establish an Immigration Police in the 2017 Budget Speech.

3.4 The Central Bank says that “Given stagnant earnings from merchandise exports, the importance of non-traditional service exports has grown significantly, although focused efforts are required to tap their full potential.”<sup>18</sup> To tap the full potential of the service sector, it is necessary to liberalize rules, encourage investment, and enable easy movement of professionals across borders. Today, these facilities are available in some form to BOI companies only. Officials have excessive discretionary authority. Workarounds abound.

4.0 Agriculture, where 27 percent of the workforce produces a mere 7.1 percent of the GDP requires serious attention. The primary focus must be on supporting the initiatives by private firms to increase high-value fruit and vegetable exports that are already underway. This will result in the improvement of standards throughout the sector and will of course improve the earnings of the smallholders now connected to export supply chains. Good agricultural practices including low/no use of chemicals and traceability will increasingly define what is acceptable in export markets. Our trade policies must on one hand strive to prevent the use of

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<sup>14</sup> GATS/SC/79, GATS/SC/79/Suppl.1, GATS/SC/79/Suppl.2

<sup>15</sup> Samarajiva, R. (2007 July 31-August 1). Sri Lanka’s telecommunications commitments under GATS: Assessment and issues for the future, Conference on the Doha Development Agenda and the Future of the Multilateral Trading System organized by the Sri Lanka Law College, Colombo. <http://www.lirneasia.net/wp-content/uploads/2007/08/rstelecomtrade1aug07.pdf>

<sup>16</sup> Bandara, K. (2016 August 24). Interview with Rohan Samarajiva: If we sign ETCA, it will become more attractive for other trade agreements, *Daily Mirror*, <http://www.dailymirror.lk/114618/If-we-sign-ETCA-it-will-become-more-attractive-for-other-trade-agreements>

<sup>17</sup> Warakapitiya, K. (2017 April 30). Acute labour shortage in Sri Lanka; 200,000 foreigners working here, *Sunday Times*, <http://www.sundaytimes.lk/170430/news/acute-labour-shortage-in-lanka-200000-foreigners-working-here-238900.html>

<sup>18</sup> Central Bank of Sri Lanka (2017). *Annual Report 2016*. Colombo: CBSL, p. 28.

- phyto-sanitary rules as non-tariff barriers.<sup>19</sup> On the other hand, we need to encourage good agricultural practices among suppliers.<sup>20</sup>
- 5.0 Given China's success in becoming the factory of the world, many fear that a manufacturing-based path for climbing out of developing-country status is no longer available.<sup>21</sup> High energy costs and labor costs that are high relative to competitor economies are significant constraints in Sri Lanka. That is why only 26.4 percent of our work force is in manufacturing. Therefore, Sri Lanka's manufacturing option must focus on high-value rather than high-volume manufacturing. This leads to the GPN solution discussed above and the need to reduce the legal and regulatory risks that GPNs are sensitive to, by embedding ourselves in plurilateral or bilateral trade agreements.
- 5.1 Effective participation in GPNs requires flexibility and certainty about importing as well as about exporting. Old-style import-substitution thinking which seeks to encourage exports while discouraging imports is inimical to effective participation in GPNs. Indeed, some scholars argue that unilateral investment and trade liberalization is superior to bilateral agreements with rigid rules of origin provisions in terms of promoting GPNs.<sup>22</sup>
- 5.2 Manufacturing enterprises find it difficult to scale up to meet the requirements of GPNs and of regional markets because of labor market constraints. These constraints need to be addressed through labor contracts, rather than opaque workarounds as at present.
- 6.0 When one looks back at Sri Lanka's first-generation reforms undertaken in the late 1970s, one sees a form of shock treatment where the domestic market was suddenly opened up with few safety nets established for those negatively impacted. The reforms that need to be undertaken now are not of the same magnitude. But it is good that the government is considering trade adjustment facilities to help specific firms retool and adjust to increased competition when tariffs, para-tariffs and barriers are brought down.<sup>23</sup>

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<sup>19</sup> Verite Research is doing excellent work in this area.

<sup>20</sup> LIRNEasia is working with the Department of Agriculture and the Sri Lanka Fruit and Vegetable Producers, Processors and Exporters Association to address these issues using modern technology.

<sup>21</sup> E.g., Roderick, D. (2015 January). Premature deindustrialization. Economics Working Papers 107, IAS School of Social Science. <http://drodrik.scholar.harvard.edu/files/dani-rodrick/files/premature-deindustrialization.pdf>

<sup>22</sup> E.g., Athukorala, P. (2010 August). Production networks and trade patterns in East Asia. ADB Working Papers on Regional Integration 56. <https://www.adb.org/sites/default/files/publication/28530/wp56-trade-patterns-east-asia.pdf>

<sup>23</sup> Samarawickrama, M. (2016 October 14). Sri Lanka is ready for business. *Daily FT*, <http://www.ft.lk/article/573733/Sri-Lanka-is-ready-for-business>

## **Annex 1: Profile of Rohan Samarajiva**

Rohan Samarajiva is founding Chair of LIRNEasia, an ICT policy and regulation think tank active across emerging Asia. He was CEO from 2004 to end 2012. His most recent co-authored book (2013) is *Information lives of the poor: Fighting poverty with technology*, published in Burmese, English, French and Spanish.

Samarajiva was Team Leader at the Sri Lanka Ministry for Economic Reform, Science and Technology (2002-04) responsible for infrastructure reforms, including participation in the design of the USD 83 million e Sri Lanka Initiative. He was Director General of Telecommunications in Sri Lanka (1998-99), a founder director of the ICT Agency of Sri Lanka (2003-05), Honorary Professor at the University of Moratuwa in Sri Lanka (2003-04), Visiting Professor of Economics of Infrastructures at the Delft University of Technology in the Netherlands (2000-03) and Associate Professor of Communication and Public Policy at the Ohio State University in the US (1987-2000). Samarajiva was Policy Advisor to the Ministry of Post and Telecom in Bangladesh (2006-09).

He serves as Senior Advisor to Sarvodaya (Sri Lanka's largest community based organization) on ICT matters and on the Privacy Advisory Group of UN Global Pulse. Samarajiva is a Board Member of Communication Policy Research south, an initiative to identify and foster policy intellectuals in emerging Africa and Asia. He is a member of the Board and former Chair of the Lanka Software Foundation and Board Member of Research ICT Africa. He serves on the editorial boards of five academic journals. He was recognized as an Internet Pioneer by the Sri Lanka Chapter of the Internet Society in 2015 and was the recipient of the Communication Research as an Agent of Change award 2009 from the International Communication Association.

He was a member of the intergovernmental Joint Study Group on the India-Sri Lanka Comprehensive Economic Partnership Agreement (2003) and chaired the GATS Advisory Committee of the Department of Commerce, Sri Lanka (2002-2004). Samarajiva chaired the expert workshop on fixed-mobile interconnection for the International Telecommunication Union (ITU) in 2000 and the first Digital Opportunity Forum for the Korea Agency for Digital Opportunity and Promotion (KADO) in 2006. More at <http://lirneasia.net/about/profiles/rohan-samarajiva/>

### **Selected trade-related publications**

Bandara, K. (2016 August 24). Interview with Rohan Samarajiva: If we sign ETCA, it will become more attractive for other trade agreements, *Daily Mirror*, <http://www.dailymirror.lk/114618/If-we-sign-ETCA-it-will-become-more-attractive-for-other-trade-agreements>.

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<sup>24</sup> Recent Daily FT op-ed articles also published in Sinhala in Ravaya.

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