Verité insights

TAs with India and China: Potential for Sri Lanka

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Sri Lanka has various levels of trade agreements (TAs) with both India and China. A new TA with China was mooted in 2014 and the appetite for that continues in the new presidency and policy context of 2015. While statistics suggested a high potential for the TA with India, in practice it has not generated a sustained growth in exports. The TA with China, therefore, needs to examine for the practical potential as well. This 'Insight' suggests that Sri Lanka's apparel and tea have the largest practical potential in a TA with China.

Potential in statistics

China and India are the two largest emerging economies in Asia. With a gross domestic product (GDP) of US $ 9 trillion, China is also the second largest economy in the world and India is the eighth largest economy (GDP of US $ 2 trillion). The appetite for imports of these two countries broadly matches their economic size. With annual imports of US $ 1,950 billion China is the second largest importer in the world and India is the 12th largest (imports of US $ 466 billion). China accounts for 10.3 percent of total world imports and India accounts for 2.5 percent.

The preponderance of Sri Lanka's exports goes to Sri Lanka's top two destinations. The USA gets 24 percent and the UK gets 11 percent. India, though it accounts for only 5.6 percent (US $ 628 million) of Sri Lanka's exports, was the country's third largest export destination in 2014. China ranked 14 in Sri Lanka's export destinations, accounting for 1.6 percent of exports (US $ 174 million).

India TA performance: Both better and worse than expected

There is a general view that the TA with India has not matched up to expectations. But there are two aspects to the performance story.

Better than expected: In the first five years of the TA (2000-2005) export performance was better than expected. During this period, India went from rank 11 in Sri Lanka's export destinations, with an export share of 1 percent (US $ 58 million), to being ranked third, with an export share of 9 percent (US $ 559 million). This was a huge surge in exports, at an annual growth rate of 57 percent.

Worse the expected: But from 2005-2014, exports to India only increased to US $ 628 million. That is, the average annual growth rate plummeted to slightly above 1 percent and the share of exports to India declined from 9 percent to 5 percent of total exports.

China has done better than India without a TA

In contrast to India, exports to China have increased much faster during 2005-2014. Even though they started from a much lower base, they went from US $ 29 million to US $ 178 million, which is an annual growth rate of nearly 20 percent.

What was the reason for the poor export performance of India in the past 10 years? Sri Lanka's initial huge growth in exports to India was driven by arbitraging the country differential in import taxes. This allowed entities set up in Sri Lanka to re-export to India, at a lower price, goods produced using raw materials imported from other markets – e.g. Vanaspathi oil (refined palm oil). But in the last 10 years these opportunities were gradually unravelled by Indian policymakers.

In contrast, the growth of exports to China has been driven by increasing Chinese demand for raw materials as well as high-quality branded products and relatively low tariff and non-tariff barriers encountered by exporters.

Potential in practice

Sri Lanka's two largest export products are apparel and tea. Together they account for more than 50 percent of Sri Lanka's exports to the world. This 'Insight' examines the relative potential through the TAs for these two products only. We focus on the emerging bilateral TA with China, because the existing Asia Pacific Trade Agreement (APTA, since 2001), that links China, Sri Lanka and India has a rather narrow and shallow scope and is not set to expand.

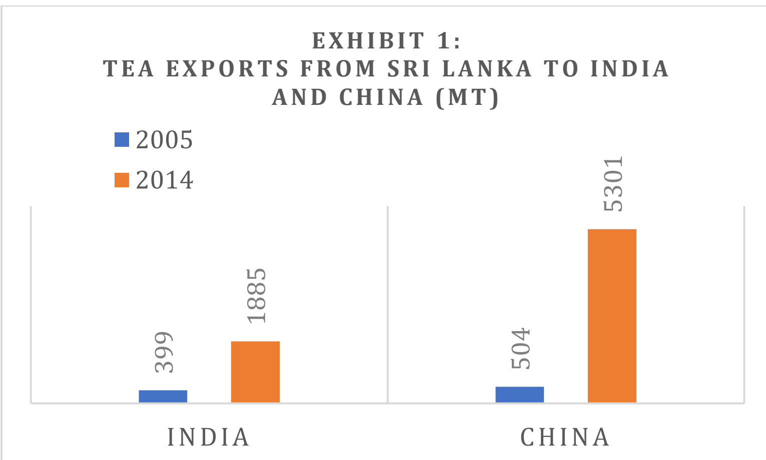
Potential for tea exports: India vs. China

The TA with India gives Sri Lanka only conditional preferential access to tea exports in the Indian market (not duty free access). Sri Lankan exporters get a 50 percent reduction in the applied tariff up to a ceiling of 15,000 MT of tea a year. In 2014, Sri Lanka only exported 1,885 MT of tea to India (refer Figure 1). Under APTA, for selected types of teas, Sri Lanka gets the same 50 percent reduction on tariff to China as well, and there is no quota.

In 2005, Sri Lanka exported similar quantities of tea to India and China (Exhibit 1). By 2014, exports to India increased close to fivefold, while exports to China increased more than tenfold. This means that at present, Sri Lanka exports three times as much tea to China than to India (Exhibit 1).

Size of market: In 2013 the value of black tea imports into China was US $ 63 million, one and half times the imports into India at US $ 41 million.

Growth of market: Black tea imports into China from the world also grew at 29 percent a year during the last decade, compared to a very low growth rate of 3 percent a year recorded by India.



Source: Sri Lanka Customs Annual Trade Statistics for 2005 and 2014

China TA concession potential: China and India are both large producers of tea but different teas. China mostly produces green tea, while India produces black tea. Producers in China are less prone to see black tea exporters, such as Sri Lanka, as a direct competitor. Therefore, the impending bilateral TA with China is tipped to provide duty-free access for 'Ceylon tea'.

Therefore, both by absolute quantity and growth rates, China is outstripping India as a destination for the export of 'Ceylon tea'. In addition, with the duty free access expected under the new TA, China will have, in practice, significantly greater potential for the export of 'Ceylon tea'.

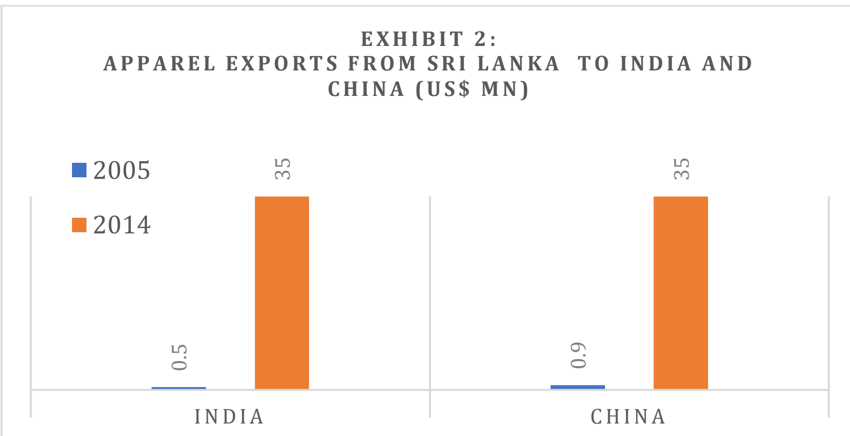
Potential for apparel exports: India vs. China

The TA with India until 2007 was extremely limited in providing access for apparel exports: duty free access was limited to an annual quota of eight million pieces made out of fabrics from India. This fabric rule was very restrictive because Sri Lankan manufactures hardly use Indian fabric. The relaxation of the rule in 2007 helped to pick up apparel exports to India.

Exports to China have done equally well despite lower concessions. Under APTA, a few items of apparel exported from Sri Lanka to China receive a duty reduction (not exemption). Sri Lanka exported apparel to the value of US $ 35 million to both China and India in 2014, recording the same rate of increase in the last decade (Exhibit 2). Even without a bilateral TA, China has been just as good as India, as an export destination for 'Sri Lankan apparel'.

Size of markets: In 2013 China imported apparel to the value of US $ 4,816 million from the world; this was 10 times higher than India, which imported just US $ 417 million.

Growth of markets: However, global imports of apparel by India have been growing faster than in China in the last decade. Chinese imports grew at 13 percent a year, while Indian imports grew at 29 percent a year.



Source: Sri Lanka Customs Annual Trade Statistics for 2005 & 2014

China TA concession potential: China's TA with East Asian countries such as Vietnam, Cambodia and Indonesia have already provided them with duty-free access for apparel. Some of these countries are larger in scale and more competitive in costs than Sri Lanka. This suggests that Sri Lanka is tipped to receive the same duty-free access in its TA with China.

Therefore, despite a slower rate of growth in apparel exports (compared to India) China is the dominant importer between the two and Sri Lanka is already succeeding in the Chinese market to the same extent as in India. In addition, with the duty-free access expected under the new TA, China will have, in practice, significantly greater potential for the export of 'Sri Lankan apparel'.

In summary

TAs, by reducing tariff and non-tariff barriers, enable countries to improve their export access to each other's markets. Sri Lanka has had a longstanding bilateral TA with India and at least in the early years this has borne dividend in terms of increasing Sri Lankan exports to India. Sri Lanka is now in the process of also negotiating a bilateral TA with China.

At present, tea and apparel account for more than 50 percent of all Sri Lanka's exports. The present 'Insight' examines the relative potential for Sri Lanka's exports of these two products to India and China.

In terms of both statistics and practice, the emerging TA with China is tipped to be much more favourable for Sri Lanka's main exports than the existing TA with India.

(Verité Research provides strategic analysis and advice for governments and the private sector in Asia. Comments welcome, email insights@veriteresearch.org)