

ASARC Working Paper 2019/03

The FTA debate in Sri Lanka: Rhetoric and Reality

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Abstract

The government of Sri Lanka has embraced free trade agreements (FTAs) as a key focus of the national trade and development strategy. This paper examines the rationale of this policy choice by analysing the trade outcomes of Sri Lanka's FTAs with India and Pakistan and the expected gains from the FTA recently signed with Singapore. The analysis is informed by the existing body of knowledge on the role of FTAs as an alternative to multilateral and unilateral liberalisation. There is strong evidence that trade gains from FTAs has been vastly exaggerated by the proponents in the Sri Lankan trade policy debate. FTAs are essentially preferential trade deals the actual trade effect of which is conditioned by the commodity coverage normally dictated by political considerations and lobby group pressure, and the 'rules of origin' relating to the eligibility for the tariff concessions offered. Even then, potential trade gains depend crucially on supply-side reforms needed to improve the country's capability to reap gains from market opening and compatibility of its trade patterns with the partner countries. Therefore the failure of the process of multilateral trade liberation under the WTO does not make a valid case for a country giving priority to FTAs. The more effective and time-honoured alternative is to undertake its own (unilateral) trade reforms needed for effectively integrating the country in the global economy combined with appropriate supply-side reforms.

Keywords: Trade policy, Export performance, World Trade Organisation, Free trade Agreement, Rules of origin.

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Introduction

Over the past three decades, free trade agreements (FTAs) have become an integral and enduring part of the global trading system. The number of FTAs notified to the World Trade Organization (WTO) increased from 19 in 1990 to 292 by January 2019.³ The government of Sri Lanka has recently embraced the newfound global fondness for FTA as a key focus of the national trade and development strategy. ‘Pursuing ... free trade agreements with all major trading partners’ figures prominently in the government’s *New Trade Policy* issued in June 2017 (Government of Sri Lanka 2017, 17). The rationale of this policy choice has, however, been intensely debated in the Sri Lankan policy circles. The purpose of this article is to assess this debate.

The paper begins with an overview of the role of FTAs as an alternative to multilateral and unilateral liberalisation to provide the context for the Sri Lankan debate. This is followed by an assessment of the trade outcome of the Sri Lanka – India free trade agreement (SLIFTA) and Sri Lanka- Pakistan free trade agreement (SLPFTA). The next section makes some observations on the likely impact of the Sri Lanka–Singapore free trade agreement (SLSFTA). The closing section offers some concluding remarks. The focus of this paper is solely on the economic rationale of FTAs, even though political considerations play a key role in the proliferation of FTAs.

³ <http://rtais.wto.org/UI/Charts.aspx>

Free trade agreements in the World Trade System: An overview

FTAs and trade opening

By definition, a free trade agreement (FTA) is a treaty between two or more countries under which *all tariffs* are eliminated on goods produced in member countries, while keeping tariffs on trade with non-member countries. However, in practice, tariff concessions are given on a selective basis, depending on lobby-group pressure in the process of FTA negotiation and perhaps genuine concerns about industrial adjustment problems associated with trade opening. The coverage of the eligibility list varies significantly among FTAs. Even for the products included on the eligibility list, tariff preferences are not automatic but subject to meeting *rules of origins* (RoOs), which are an integral part of any FTA. For these reasons, the term ‘free trade agreement’ is, in fact, a misnomer; the more meaningful term, which is preferred by prominent trade economists, is ‘preferential trade agreement’ (PTA). However, in this article we stick to the popular term, FTA (Bhagwati et al 1998, Bhagwati 2008).

In an FTA, unlike in a customs union (CU),⁴ the participant countries maintain their own external tariffs, which usually differ between member countries, while offering concessional tariffs to the member countries. Thus, it is necessary to combine tariff concessions with RoO to prevent ‘trade deflection’, that is, transshipment of goods from non-member countries through the member country with the lowest external tariffs to other FTA members. If eligibility criteria imposed for the identification of the true originating of products are stringent and the related administrative mechanism is cumbersome or corrupt, then RoOs can diminish, or even render worthless, the preference margin offered to traders (Krishna 2006). There is always possibility to tweak RoOs or delay the approval process in response to lobby group pressure to undermine the expected trade opening under an FTA (Falvey and Reed 2002). Because of these reasons, how the RoO are designed and implemented matter a lot for understanding how much market access an FTA really confers.

The RoO are set based on two criteria: regional value content (RVC) and change of tariff classification (CTC) (Krishna 2006, Athukorala & Kohpaiboon 2011). The RVC criterion requires that the cost of material and processing cost within the FTA member countries

⁴ A CU is an FTA with the member countries imposing a common external tariff on a given product (European Union (EU), Central American Common Market (CACM) and Caribbean Community (CARICOM) are examples). Given common external tariffs, transshipment is not an issue relating to CUs (Panagariya 2000)

represent a set minimum proportion of the value of the final product. The CTC criterion requires that the ‘non-originating material’ (that is, intermediate inputs imported from non-member countries) used in production belongs to a different commodity code (category) of the Harmonised System (HS). Until recently, the RVC criterion was by far the dominant norm used in setting RoO. Designing and application of RoOs have become increasingly complicated in recent years because of the rapid growth of international fragmentation of production: the geographical separation of activities involved in producing a good (or service) across two or more countries within vertically integrated production systems. It is difficult to apply the standard value-added criteria in a context where trade in parts and components and final assembly occur in different countries, because assembly in a given location within a production networks has a very thin value-added content. For this reason, most FTAs now use a mixture of the two criteria.

In applying the CTC criterion, the shifting of HS classifications is usually expressed at the chapter (two-digit), heading (four-digit) or sub-heading (six-digit) level of the HS system of classification. The specific level of the HS classification chosen makes a significant difference in the case of manufactured goods, as the good is usually ‘made’ from the other items in the given chapter or the heading to which it belongs. Specification of the ‘HS change level’ by chapter is more restrictive than a change at the heading level, which in turn is more restrictive than a change at the sub-heading level.

Within the limits set by the actual products coverage and RoOs, the actual trade outcome of an FTA depends on two key factors: ‘supply response’, and ‘trade compatibility’. The term ‘supply response’ here refers to capacity of an economy to increase supply of exports as well as to achieve productivity gains by facing import competition under an FTA. It depends on a wide range of factors, many of which fall outside the ambit of an FTA. These factors include not only trade and industry policy, but also the country’s trade-related institutional infrastructure, human resource development and all the other elements determining the flexibility of the economy responded to emerging opportunities in the global economy.

The term ‘trade compatibility’ means the extent to which the trade patterns of a given country match with that of its partner country: whether products exported by a given partner country are the ones mostly imported by the other partner country and the vice versa. The degree of trade compatibility depends on a country’s comparative advantage in international production, which intern depends on the nature of resource endowment and the stage of economic development. The economic size of the country also matters because larger countries

generally tend to have a more diversified product mix. Most of the FTAs listed in the policy debate as ‘success’ cases (such as the North American Free Trade Agreement (NAFTA), Vietnam – US FTAs and FTAs of Australia and New Zealand with China) are between countries with strong trade compatibility on both import and export sides.

In recent years, FTAs have evolved and gone beyond trade liberalisation into provisions for institutional harmonization between the member countries relating to intellectual property, health and safety issues, labour standards, labour migration, investment proportion and protection, banking and finance, investor-state dispute settlement and others. The FTAs with such multiple provisions are now popularly known as ‘modern FTAs’. The stated rationale for broadening the coverage of reforms is to achieve deep economic integration among the member countries going beyond what can be achieved through the shallow cross-border integration through trade reforms. There is, however, scepticism on how much deeper FTAs can go beyond the possibilities offered by the WTO process or unilateral reforms. These concerns have been widely debated relating relating in particular to provisions on cross border investment and labour migration (Krishna 2014).

Trade effects of FTAs

With the proliferation of FTAs as mentioned at the beginning of this paper, the share of world trade accounted for by member countries of FTAs increased from 28% in 1990 to over 55% by the end of the first decade of 2000s (WTO 2011). These figures are often misleadingly quoted in the Sri Lankan policy debate to imply that Sri Lanka is going to be marginalised in world trade unless get into the FTA game (Government of Sri Lanka 2017, Ratnayake 2017).

However, the recorded total trade of FTA partner countries is *not* the same as trade occurring under trade preferences offered by FTAs. According to calculations by the World Trade Organisation (WTO), only 30% of world trade takes place on preferential basis, but this figure drops to 16% when trade within the European Union (which is a CU) is excluded (WTO 2011). The available evidence on the operation of FTAs in Asian countries also suggests that the utilisation of tariff concessions offered under FTAs are rather low, ranging from 5% to 20% across different product categories (Cheong and Choc 2009, Jongwanich and Kohpaiboon 2017, Menon 2014,). There is also evidence that the utilisation rates are often firm or industry specific. Normally, utilisation rates are high for large firms and firms with close trade and FDI ties or those located in specific industries where complying with RoO requirements are simple

and straightforward. The upshot is that, not only the actual trade effect of FTA is low, but also FTAs are unlikely to have the potential to promote trade in a neutral and broad-based fashion.

Why the actual trade effect of FTAs is much lower than what the FTA enthusiast claim? First, much of the trade between FTA members is in goods on which MFN tariff rates are zero or rather small in the first place. Most countries also provide duty free accession to imported inputs used in export production through free trade zone (FTZ) schemes and duty drawback schemes. Second, goods that are subject to high tariffs are often excluded from the list of products earmarked for duty concessions in most FTAs. Third, world electronics trade is virtually free of duty thanks to WTO's Information Technology Agreement (ITA), which came into effect in 2006 (WTO 2017). Fourth, and perhaps more importantly, traders in many countries simply ignore FTA tariff concessions because of the administrative cost and other administrative complications.

The ITA, concluded at the WTO's Singapore Ministerial Conference in 1996, is a pluralistic agreement that requires participant countries to eliminate tariffs on a specific list of information technology products (computers, semiconductors, semiconductor manufacturing and testing equipment, telecommunication equipment, computer software, and scientific instruments). So far 75 countries have signed the ITA. These countries account for about 97 % of world trade in IT products. IT products covered by the agreement amount to about 34% of total world manufacturing trade. A country that becomes a signatory to a pluralistic agreement opens its market to both member- and non-member countries.

A point often made by proponents of FTAs is exports from Sri Lanka are not growing fast because the country is lagging the fast-growing countries in Asia in signing FTAs. (Government of Sri Lanka 2017, Ratnayake 2017). This observation is simply a misinterpretation of 'coexistence' as 'causality'. These countries (and, in fact, all high performing countries in East Asia) had become dynamic exporting nations well before the new penchant for signing FTAs (Perkin 2013). In fact, South Korea and Taiwan achieved super-past export growth in the 1980s in a hostile international environment with high tariffs and quantitative restriction in most destination countries. Broader unilateral reforms with emphasis on export orientation was the key to their export success (Rodrik 2018a). In any case, as noted above, the available evidence suggests that only a small share of Asian countries' trade occurs under the existing FTAs: FTAs are mostly 'window dressing'. It is also important to note that most of these countries are signatories to the ITA and hence FTAs are virtually irrelevant for the electronics industry, which cover on average over a half of each of these countries exports.

The proponents of FTAs may ask why countries are so enthusiastic in signing FTAs if the actual trade flow effect is very low. This issue has been well addressed in the recent literature on FTAs (Rodrik 2018b, Cattaneo 2009, Irvin 2018, Krishna 2014). First, countries sign FTAs as much for foreign policy and security reasons as for economic reasons. Second, there is the so-called ‘bandwagon’ effect, the tendency to follow others without considering actual economy implication. Third, as discussed below, there is a tendency on the part of the politician and technocrats to place greater emphasis on the FTA path to trade opening for various non-economic reasons. In sum, an FTA is rarely, if ever, based on a single motive, the contracting parties to an FTA often have different and sometimes even conflicting objectives

The proponents of FTAs often mention that the increased emphasis on signing FTAs reflects deep frustration resulted from the failure to make substantial progress with the Doha Round of Multilateral trade negotiation initiated in 2001. However, an inspection of the annual data on the reporting of FTAs to WTO clearly shows that proliferation of FTAs started around the time of successful completing of Uruguay Round negotiation that significantly brought down trade barriers worldwide under the newly restabled WTO. Over 60 of the existing FTAs came into effect between 1994 and the year of launching of the Doha Round (2001), when there were high hopes of further reforms under the WTO. It seems that the launching of the NAFTA in January 1994, a landmark in the history of regional trading arrangements, and positive prognoses made by some prominent economists of NAFTA’s trade effects (eg Summers 1991, Krugman 1991, seem to have had a significant demonstration effect on the proliferation of FTAs in the ensuing years.

Do FTAs play a vital role in attracting foreign direct investment? The available empirical evidence on this issue is mixed, at best. Moreover, the available ‘positive’ evidence relates predominantly to FTAs involving developed and developing countries (Stevens et al. 2016). The best inference possible from the available evidence is that FTAs can play a role at the margin if and only if other preconditions required for making the country an attractive place for FDI are met. It is also important to note that signing bilateral investment protection treaties (BIPTs) is an alternative to FTAs for facilitating FDI. However, regardless of whether a country sign an FTA or a BIPT, the outcome depends on complementary supply-side reforms (Dollar et al 2005, Hallward-Driemeier 2003, Stevens et al. 2016).

Often ignored in the FTA debate in Sri Lanka and elsewhere untoward developmental implications of the newfound enthusiasm for signing FTAs. In the negotiation and

implementation process of an FTA, the attention of policy makers is often distracted from these vital supply-side issues. This is because FTA negotiation has its own attractions to the political leadership and the high-level technocrats compared to domestic reforms. FTAs help attracting media attention ('photo opportunities') and foreign dignitaries visiting countries like (or request) to sign agreements. Negotiating FTAs is also relatively less cumbersome compared to handling messy domestic supply-side issues. Whatever the drivers may be, the policy bias in favour of FTAs has significant (but hidden) cost to the economy: in a country with limited technocratic and institutional capabilities. There is always the possibility of a costly trade-off between signing FTAs and undertaking much needed supply-side reforms (Cattaneo 2009, Bhagwati et al 1998).

With the proliferation of FTAs, tariff structure of a country will become highly differentiated, giving rise to inefficiencies in resource allocation. Overlapping of the standard MFN tariff and FTA tariff concessions, and multiple 'rules of origin' attached to the later complicate customs of administration and weaken efficiency improvements in the custom system and opens up opportunities for corruption (Bhagwati 2008, Krishna 2014, Arvin 2008).

FTAs and Sri Lanka's trade performance

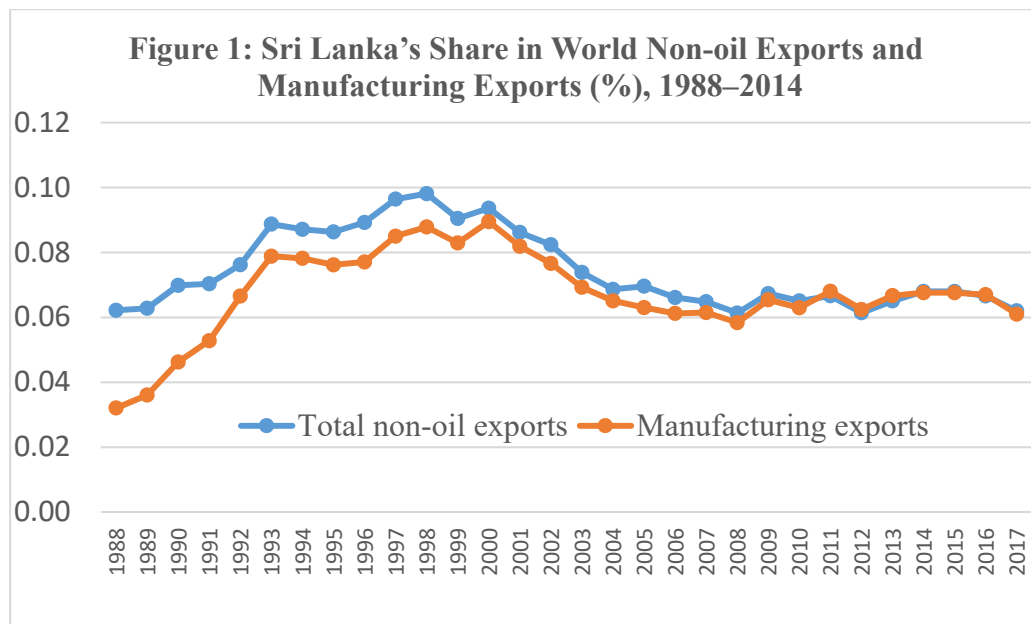
This section begins with a stage-setting discussion of the relative importance of supply-side and demand-side factors for Sri Lanka's export performance and the compatibility of Sri Lankan trade patterns with that of the existing and potential FTA partners. This is followed by a preliminary assessment of the trade outcome of SLIFTA and SLPFTA.

Supply and Demand in export expansion

Perhaps the best readily available indicator of the relative importance of demand and supply factors in determining a country's export performance is its share in total world exports. A continuously decline in the world market share implies that the country has not been able to exploit existing world market opportunities because of supply constraints. If that is the case, market opening by signing FTAs is unlikely to have an appreciable effect on export expansion.

Figure 1 depicts Sri Lanka's share of world exports separately for total exports (excluding petroleum) and manufactured goods. Sri Lanka's share in world exports increased from 0.05% in the mid-1980s to about 0.11% in 2000, underpinned by significant trade and FDI reforms undertaken concurrently during this period. It has then declined continuously, reverting to the level in the 1980s by 2017. The time patterns of both data series are strikingly

similar. This suggests that slowing of the export growth of both primary products and manufactured goods during the last two decades has been driven primarily by domestic supply-side factors. Exports from the country has failed to keep up with the expansion of world demand. There is ample evidence that policy slippages on the supply side, rather than failure to join the FTA-club was the fundamental reason behind this lackluster export record (Rajapatirana 2016, Athukorala 2017).



Source: Data compiled from UN Comtrade database.

The data presented in Table 1 on Sri Lanka's exports to the European Union and the utilisation rates of GSP concessions reinforce the inference made above. In fact, GSP utilisation rate is a much better indicator of the relative importance of supply-side factors relating to the FTA debate: In terms of facilitating export expansion through concessionary market entry, a GSP scheme is similar to an FTA even though the underlying modalities are different.

The GSP utilisation rate of Sri Lankan exports to the EU has declined sharply from about 73.8 in 2009 to 54.8 in 2017, with only minor year-to-year changes. The country-level GSP utilisation rates for the same data source (not reported here for brevity) suggest that Sri

Lanka's average utilization rate is lower than all GSP-eligible countries in Asia, let alone most GSP-eligible African countries.⁵

Table 1: Sri Lanka's exports to the European Union (EU), 1999-2017

	Exports (Mn Euro)			GSP utilisation rate
	Total exports	GSP eligible exports	Exports under GSP	
2009	1947	1615	1192	73.8
2010	2123	1745	1270	72.8
2011	2239	1775	1177	66.3
2012	2250	1763	1072	60.8
2013	2039	1644	989	59.6
2014	2161	1798	1072	59.6
2015	2340	1967	1078	54.8
2016	2403	2030	1106	54.5
2017	2635	2264	1240	54.8

Source: Compiled from data obtained from the EU Statistical office.

Trade compatibility

The trade compatibility index estimated for Sri Lanka's import and export with India, Pakistan, Singapore and a sample of other countries during 2015-17 are reported in Table 2. Three-year averages are used here in order to reduce the influence of any annual irregular variation in trade data. A high coefficient of compatibility on the export side implies that an FTA between Sri Lanka and an importing country would have a high likelihood of increasing exports from the former to the latter. Likewise, high coefficient of compatibility on the import side implies that an FTA with a given country has a high likelihood of increasing imports to Sri Lanka from that country.

It is important to note that this index provides for only an ordinal inference: we can infer from it only whether one agreement make more sense than other from the point of view of a given country. The index cannot yield an inference of cardinal nature, such as the expected size of trade, or trade creation or trade diversion following one agreement or another no, for that matter, will they tell whether the agreement is expected to be 'good' or 'bad' (Michaely 1996, Yeats 1999).

⁵ Data are not yet available to assess the impact of the recent reintroduction of GSP+.

The value of the index is significantly larger for both export and imports with developed countries (USA, Germany and UK) compared to countries in the region, which are the focus of current FTA negotiations in Sri Lanka. This contrast is consistent with the available evidence that trade gains for developing countries from their FTAs with developed countries (South – North agreements) is likely to be greater compared to those among developing countries (South-South agreements) (Stevens et al 2015).

Table 2: Indices of compatibility of Sri Lanka’s trade with selected countries, 2015-17¹

	Exports (C _{xjm_k}) ¹	Imports C _{m_jx_k} ²
India	0.21	0.68
Pakistan	0.25	0.35
Singapore	0.14	0.31
China	0.11	0.71
Thailand	0.09	0.23
USA	0.68	0.61
European Union	0.67	0.58
Germany	0.64	0.62
UK	0.59	0.48

Note:

(1) Three-year averages (Three-years averages are used here in order to reduce the influence of any annual irregular variation in trade data.

(2) Index of compatibility of exports of country j (Sri Lanka) with imports of country k

$$C_{x_j m_k} = 1 - 0.5 \sum |x_{ij} - m_{ik}|$$

(3) Index of compatibility of imports of country j (Sri Lanka) with exports of country k

$$C_{m_j x_k} = 1 - 0.5 \sum |m_{ij} - x_{ik}|$$

where, x_{ij} share of good i in total exports of country j , m_{ij} share of good i in total imports of country j , x_{ik} share of good i in total exports of country k ; m_{ik} : share of good i in total imports of country k : and $|$ indicates absolute value (i.e. regardless of sign)

Source: Computed using data from UN *Comtrade* database (SITC Rev 3, at the five-digit level)

Sri Lanka’s trade compatibility with India on the exports side is much smaller (0.21) compared to that on the import side (0.68). There is no notable difference between the export complementarity index and imports complementarity index relating to Pakistan, and the latter is much smaller (0.35) compared to that with India (0.68). As we will see below Sri Lanka’s trade patterns under the FTAs with these two countries are broadly consistent with one would expect based on trade compatibility indices. The indices also suggest that, under the existing

trade patterns, we cannot expect much export expansion from FTAs with Singapore, Thailand or China.

Sri Lanka – India Free Trade Agreement (SLIFTA)

The SLIFTA was signed in December 1998 and it became operational in March 2000. The agreement covers only merchandise trade (traded goods). In 2005, Sri Lanka and India initiated negotiations to extend the SLIFTA into a Comprehensive Economic Partnership Agreement (CEPA), which would cover services and investment in addition to broadening commodity coverage of trade liberalisation.

The SLIFTA adopts a negative list approach to trade liberalisation. To begin with India-Sri Lanka FTA (ISLFTA), India provided Sri Lanka duty concessions (90-100% duty exemptions) on 1351 items (at the six-digit level of the Harmonized System). However, tea and garments produced with non-Indian fabrics were subject to import quotas and could enter India only through designated ports. In early 2003, 2,799 more items were added to the concession list, port-of-entry restrictions on tea and garments were relaxed and the quota on garment imports was expanded. Trade preferences granted by Sri Lanka to India are more extensive and larger in proportional terms, but concessions have been granted mostly on products for which MFN tariffs are already very low. Most of food products exported from India, which have considerable potential for rapid market penetration in Sri Lanka, remain on the negative list with high import duties. The RoOs of the agreement are a combination of RVC and CTS: value added 35% of FOB value if the inputs come from both countries or 25% if inputs conform one of the two countries.; final product have a different classification compared to intermediate inputs at the 4-digit HS level. The agreement incorporates special and differential treatment provisions to factor in Sri Lanka's smaller economic size (Kelegama 2014, Weerakoon 2001).

A claim made in various government reports and by proponents of FTA is that Sri Lanka has been a net gainer of the SLIFTA: exports under the agreement account for over 60% of total exports to India whereas only a smaller share of import (about 10%) is covered by the agreement (Central Bank of Sri Lanka 2018, Kelegama 2014). However, a close look at the data suggests that this is a rather simplistic interpretation of the actual trade outcome under the agreement (Table 2).

Table 2: Sri Lanka – India merchandise trade, 2000 -2017

	Exports (USD mn)			Imports (US\$ mn)			India's share in Sri Lanka's trade (%)		Trade balance as % of exports
	Total	SLIFTA	SLIFTA share in exports (%)	Total	SLIFTA	SLIFTA share in imports	Exports	Imports	
2000	56	9	16	600	54	9	1.7	14.1	
2001	70	16	23	601	113	19	2.3	14.4	-757.1
2002	169	114	68	834	82	10	3.7	18.2	-394.0
2003	241	239	99	1076	150	14	5.0	22.1	-346.2
2004	385	340	88	1342	395	29	7.1	22.9	-248.1
2005	559	543	97	1399	246	18	8.9	20.7	-150.3
2006	494	431	87	1822	459	25	7.1	21.2	-268.8
2007	516	398	77	2785	385	14	6.7	23.1	-439.3
2008	418	309	74	3007	541	18	5.2	24.5	-619.2
2009	325	219	67	1710	372	22	4.5	17.8	-426.3
2010	467	358	77	2546	574	23	5.5	19.1	-445.7
2011	522	392	75	4349	580	13	4.9	21.9	-733.9
2012	566	380	67	3517	156	4	5.8	19.0	-521.0
2013	543	369	65	3093	393	13	5.2	17.6	-469.2
2014	625	376	60	3978	540	14	5.6	20.7	-536.6
2015	643	406	63	4273	240	6	6.1	22.5	-564.6
2016	551	375	68	3828	187	5	5.4	19.9	-594.4
2017	689	442	64	4496	257	6	6.1	21.6	-552.1

Source: Combined from data provided by the Department of Commerce and from The Central Bank, Annual report (for total trade)

There was a surge of exports from Sri Lanka to India during the first seven to eight years following the agreement came into force. This was mainly due to exports of vanaspati (refined hydrogenated oil, listed under HS 151620) and primary copper (extracted from imported from scrap metal) (HS7403). These products accounted for over nearly 60 % of total Sri Lankan export to India during this period. However, the expansion of these exports was not driven by Sri Lanka's comparative advantage in their production compared to India. Rather, it was because Indian manufactures invested heavily in Sri Lanka to produce these products to reap gains from lower Sri Lankan tariffs on required main inputs (crude palm oil for Vanaspati production and scrap metal for extracting primary copper) and preferential (under zero tariff) entry of the end products to India under the FTA (Athukorala 2014).

The export dynamism of vanaspati and copper was short lived, however. Under strong pressure from the Indian Vanaspati Producers Association, India subsequently cut its import tariffs on palm oil from 70% in the early 1990s to 7.5% in January 2008 and then to zero in March 2008 and imposed stringent tariff rate quotas on vanaspati imports from Sri Lanka. Consequently, vanaspati exports disappeared from Sri Lanka's export list from about 2009. In the case of copper, from 2008 India began to regulate imports from Sri Lanka based on its own domestic value addition estimates made using the London Metal Exchange prices. This remarkable policy response was based on India's concerns about the validity of the RoO certificates issued by the Sri Lankan Department of Commerce. Following the introduction of the stringent procedure for approving market access, a large proportion of Sri Lankan copper exports Lanka because ineligible for entering India under the FTA tariff concessions.

During the ensuing years, Sri Lankan exports to India of some other products were also subject from time to time various forms of 'administrative protection' such as stringent food safety regulations, delaying customs clearance and changes made in the list of ports demarcated for the entry of Sri Lanka goods (Pal 2015). There is also anecdotal evidence that some Sri Lanka exporters have begun to shun the FTA and export under the MFN tariffs because of the cumbersome and costly procedures involved in obtaining RoO certificates and delays in import clearance at the Indian ports.

Reflecting the combined effect of all these factors, the share of Sri Lanka's exports to India covered by the SLIFTA declined from a peak of 97% in 2005 to about 64% during the past five years. The share of total exports to India declined from about 8.5% in the early 2000s to 6.4% during 2015-17. Even these figures need to be treated with caution because of some cases of alleged 'trade deflection' (that is, rerouting some products) of some products from other countries to India via Sri Lanka through alleged manipulation of the country of origin certification. There have been a number of highly-publicised cases of rerouting via Sri Lanka to India of areca nuts from Indonesia and black pepper from Vietnam.

The food safety regulations and other administrative restrictions imposed by India on imports from Sri Lanka from time to time clearly support the view that, in practice, implementation of a bilateral FTA is highly susceptible to domestic lobby group pressures, particularly when the FTA partner is a large country with greater bargaining power. Presumably, a small country like Sri Lanka has a much better chance of resolving these issues through the multilateral dispute settlement process of the WTO. Involvement of other WTO

members is the dispute settlement process could help overcome resistance arising at the bilateral level. An interesting example is the resolution of the Sri Lanka– EU dispute relating to cinnamon exports (https://www.wto.org/english/news_e/news06_e/sps_oct06_e.htm). In 2006, some member countries of the EU introduced a de-facto banned on imports of cinnamon from Sri Lanka because of sulphur dioxide (SO₂) content. Sri Lankan authorities were able to successfully resolve the dispute by appealing to the WTO under the Sanitary and Phytosanitary (Animal and Plant Health) agreement. The settlement of the issue involved adoption of a new international food safety standard for cinnamon that helped ensuring transference in food safety monitoring in international cinnamon trade.

It is often claimed that, under the SLIFTA India has become the second largest destination for Sri Lankan exports. However, India accounts for only about 6% of Sri Lankan exports compared to the 26% share of the largest destination country, the USA. A close look at the commodity composition of exports cast doubt about possibilities for further expansion of exports from Sri Lanka to India. Most of the agricultural products, which accounts for the bulk of total exports to India are subject to supply constraints. Sri Lanka's total (world) exports of some agricultural products (cinnamon, cloves, black pepper) have increased at a much slower rates or even hardly increased, suggesting that increase in exports to India involved diversion of exports from other markets propelled by duty free market access rather than by a net increase in domestic production. Most of the manufactured goods exported from Sri Lanka under the FTA benefit from high MFN import tariffs in India, and are, therefore, susceptible to further unilateral trade liberalisation in India. Garments, the main manufacturing export of Sri Lanka, account for less than 3% of Sri Lankan exports to India. As a labour abundant country, it is unlikely that India is prepared to substantially expose its garment industry to competition from Sri Lanka on a bilateral basis.

The picture is very different on the import side. The share of imposts from India has on average accounted over 20% of Sri Lanka's total merchandise exports during 2000-17, even though, imports under SLIFTA account for a small and declining share in Sri Lanka's total imports from India, averaging to a mere 6% during this period. This pattern is consistent with Sri Lanka's high trade compatibility (explained below) with India on the import side. The high compatibility is in fact what we would expect in trade between a small country and a giant trading pattern with a highly diversified production base. India has a even though large and diversified production base compared to Sri Lanka and most of the products in Sri Lanka's import baskets are produced in India at internationally competitive prices. Moreover, Sri Lanka

is a low-tariff country in the region with significant number of zero-duty tariff lines. Given the strong trade compatibility and low import tariff, tariff concessions granted under the SLIFTA are not a significant determinants of Sri Lanka's imports from India. On the export side, the small share of exports to India (6%) seems to reflect the low degree of compatibility between commodity composition of Sri Lanka's exports and that of India's exports. India has strong cooperative advantage in world trade in most labour- and resource intensive products exported from Sri Lanka.

There was a notable decline in Sri Lanka's bilateral trade deficit with India during about the first five years following the SLIFTA came into effect. This declining trend has disappeared since then. Over the past decade, the bilateral trade deficit amounted to about five times of total exports to India without showing any declining trend.

Given the glaring asymmetry on export and import sides between Sri Lanka and India under the SLIFTA, India has an exorbitant bargaining power in trade negotiation with Sri Lanka. This arguably accounts for India's ability to control imports from Sri Lanka by resorting to various non-tariff barriers (Pal 2015), notwithstanding its stated commitment to honour special and differential treatment provisions. The experience so far under the SLIFTA, therefore, does not augur well for Sri Lanka to obtain further market access through the ongoing ETCA negotiations.

Si Lanka Pakistan Free Trade Agreement (SLPFTA)

The SLPTFA was signed in July 2002 and it came to effect in June 2005. In terms of the coverage of the concessions ('positive') list and the RoOs the agreement is virtually a mirror image of the ISLINDFA (Ahmad 2012).

SLPFTA cover about 80% of total Sri Lankan exports to Pakistan, but these exports account for a mere 0.7% of total Sri Lankan exports. Agricultural products and agro-based raw materials (natural rubber, vegetable products, coconut and some spices) dominate the export mix. The data for the past five years shows that the average utilisation of TRQs offered under the agreement has been very low: tea 13%; garments 4%; betel leaves: 6%. For tea and garments, higher prices of Sri Lankan products compared to imports from other sources are considered a major reason for the low quota utilisation. Sri Lankan garment producers have significantly upgraded their product mixt during the past few decades and Pakistan is not attractive market for these products (PBC 2018).

Table 4: Sri Lanka-Pakistan trade, 2012-2017

	Exports (US\$ mn)			Imports	Pakistan's share in Sri Lanka's trade (%)		Trade balance as % of exports
	Total	SLPFTA	SLPFTA share in imports (%)		Exports	Imports	
2012	82.7	60.4	73.0	353	0.8	1.8	-326.6
2013	83.0	59.2	71.3	378	0.8	2.1	-355.1
2014	74.3	51.8	69.7	280	0.7	1.4	-277.1
2015	73.1	58.8	80.5	297	0.7	1.6	-306.3
2016	63.8	51.5	80.8	304	0.6	1.6	-376.5
2017	74.0	60.3	81.5	349	0.7	1.7	-371.6

Source: Compiled from data provided by the Department of Commerce and from The Central Bank of Sri Lanka, *Annual Report* (for total trade)

Imports from Pakistan account for about 1.7% of total Sri Lankan imports. The product mix consists of woollen fabrics and bed linen, cements, fertilizer, and basmati rice. There is no evidence of a notable increase in imports following the FTA came into effect.

At the time of negotiating the agreement, the Sri Lankan authorities expected that the country's garment industry would benefit from procuring cotton yarn and fabrics from Pakistan (World Bank 2005). This expectation has not materialised. Pakistani yarn and fabric accounts for a small share (less than 2%) of these imports to Sri Lanka. This was presumably because garment producers must procure high quality inputs from established sources to meet the quality requirements demanded by the international buyers. Moreover, garment producer in Sri Lanka have duty free access to imports from any country under the FTZ scheme and duty rebate provisions available to non-FTZ firms.

Overall, trade patterns under the SLPFTA are consistent with our analytical prior that trade outcome under an FTA depend crucially on the trade compatibility between the partner countries. Of course. The lack of awareness of among the business community of the trade concessions offered in the agreement, as noted in a recent study by the Pakistan Business Council (Pakistan Business Council 2015), could have played a role at the margin.

The Sri Lanka – Singapore Free Trade agreement (SLSFTA)

Unlike the SLIFTA and the SLPFTA, SLSFTA is a modern FTA. It has a wider range of reform provisions going beyond liberalisation of trade in goods to include other areas such as services, movement of professionals, telecommunications and Electronic Commerce. Intellectual property rights, government procurement. Overall, the subject coverage is similar to the other FTAs involving Singapore. The SLSFTA was signed on 1 May 2018. However, whether or when and in what form will the agreement come into force remain uncertain following the release in last November 2018 of the report of the Committee of Experts (CoE) appointed by the President to evaluate it.

Singapore is one of the most opened trading nations in the world. Singapore's average MFN applied duty rate is zero for all imports other than imports of beverages and tobacco for which the averaged rate varies from 1.6% to 85% (WTO 2018). Thus, the SLSFTA is unlikely to have a direct impact on Sri Lanka's exports to Singapore.

Some commentators have expressed concern that, under the agreement, Sri Lanka would be able to export to other Southeast Asian countries with which Singapore has entered into free trade agreement. It simply reflects the popular media practice of treating 'trade within FTAs' as 'free trade'. This view ignores the fact that RoOs, which are an integral part of any FTA, preclude transshipment of goods to a third country through a FTA partner country.

Sri Lanka has little trade compatibility with Singapore on the import side (Table 2). This is because, over the past three decades, Singapore's export structure has undergone a dramatic transformation. Now petrochemicals, pharmaceuticals, high-tech parts and components of electronics and surgical and scientific equipment dominate the commodity composition of exports. Singapore is not a supplier of assembled (final) consumer electronics and electrical goods, automobiles, and low-end parts and components of these products, which dominate Sri Lanka's manufacturing imports. Therefore, the market penetration effect in Sri Lanka of Singapore products under the agreement is likely to be negligible.

There is a fear that the agreement could open the door for industrial waste and other environmentally harmful products to enter Sri Lanka. This would entirely depend on the implementation of the RoOs of the agreement by the Singapore authorities. Given the well-functioning institutions in Singapore with a proven record of adherence to the rule of law, one can hope that there would be little room for tweaking or lax implementation of the RoOs on Singapore's part.

The Sri Lankan authorities anticipate that SLSFTA would help linking the Sri Lankan manufacturing sector to global production networks (global manufacturing value chain) (Central Bank of Sri Lanka 2018). How this would happen is not clearly stated in the related government documents. One possibility could be Singapore-based firms operating within production networks relocating some sediments/tasks of the firms in Sri Lanka to exploit advantages from relative production cost differences. Indeed, this process helped spreading production networks from Singapore to the neighbouring countries during the period from about the mid-1970s to the late 1990s (Athukorala and Kohpaiboon 2014). However, because of the dramatic industrial transformation noted above, industries such as semiconductor and hard disk drive with potential to shift relatively low-end activities to low-cost locations have already disappeared from Singapore.

It is important to note that, the electronics firms currently in operating in Sri Lankan manufacturing export predominantly to countries like Japan, USA, Germany and some European countries. Their exports to Singapore and other ASEAN countries are minuscule, notwithstanding duty free access to these markets under the WTO's Information Technology Agreement.

Even if there were some opportunities for production relocation, whether the FTA would be an effective vehicle for facilitating the process is highly debatable, for two reasons. First, the very essence of global production sharing within global production networks is locating different segments of the production process globally, rather regionally or bilaterally. The relative cost advantage of producing/assembling a given part or components in the supply chain need not necessarily lie in a country within the jurisdictional boundaries of a specific FTA.

Second, there are formidable complications relating to the application of RoOs for trade within global production networks. Most of the task/segments produced/assembled within production networks have very thin value added margins in each location. In addition, most of imports and export of parts and components related with production fall under the same HS 4-digit classifications. Therefore, the identification of the origin of trade within production network for granting tariff preferences becomes a major challenge (Athukorala & Kohpaiboon 2011).

Put simply, the rise of global production sharing strengthens the case for multilateral (WTO-based) or unilateral, rather than regional (FTA) approach, to trade liberalisation. To

quote Victor Fung, the Honorary Chairman of Li & Fung, the world's largest supply-chain intermediary based in Hong Kong,

‘Bilateralism distorts flows of goods In structuring the supply chain, every country of origin rule and every bilateral deal has to be tackled on as additional considerations, thus constraining companies in optimising production globally’

Victor Fung, *Financial Times*, November 3, 2005.

These considerations suggest that more appropriate policy option for facilitating a country's engagement in global production network is unilateral liberalisation or becoming a signatory to the ITA. Both policy options assure unconditional duty-free access to the required inputs. The case for such broader liberalisation, rather than following the FTA route lies in that global production sharing is a global phenomenon, rather than a regional or bilateral phenomenon.

One of the main envisaged gains to Sri Lanka from the SLSFTA is attracting FDI from Singapore. It is expected that the provisions in the investment chapter (Chapter 10) (safeguards against expropriation, most-favoured nation treatment, repatriation of capital and return from investment) would entice Singapore investors to come to Sri Lanka. However these provisions are exactly similar to those embodied in the Bilateral Investment Protection Treaty (BIPT) between the two countries that has been in force over three decades (since September 1980).⁶ Notwithstanding this long-standing treaty, Sri Lanka has so far been able to attract only a tiny share of rapidly expensing overseas FDI from Singapore. The total stock of our FDI from Singapore increased from US\$32 billion 1994-5 to over 560 billion in 2015-16 (Table 4). However, during this period Singaporean FDI in Sri Lanka amounted to a mere US\$ 1.2 billion (based on investment approval records of the Board of Investment). This comparison is much in line with the available multicountry evidence that a BIPT (or an FTA with an FDI chapter, for that matter) is unlikely to entice foreign investors unless they are appropriately embodied in a broader reform addenda to improve the overall investment climate of the country (Hallward-Driemeier 2003).

⁶ <https://investmentpolicyhub.unctad.org>

Table 4: Singapore's Direct Investment Abroad. 1994-2016, two-year averages (%)

	1994-95	1999-00	2004-05	2009-10	2015-16
Manufacturing	24.0	24.8	22.1	21.0	17.3
Construction	1.2	0.8	0.4	0.3	0.3
Wholesale & Retail Trade	8.2	6.4	5.6	6.2	8.4
Accommodation & Food Service Activities	2.2	1.8	1.2	0.9	0.6
Transport & Storage	4.1	4.1	4.0	2.6	2.9
Information & Communications	0.0	2.1	5.1	4.4	4.3
Financial & Insurance Services	49.2	48.6	53.7	49.3	48.9
Real Estate Activities	7.0	7.3	4.1	7.7	7.6
Professional, Scientific & technical, Administrative & Support Services	2.9	2.5	1.8	1.7	3.2
Others	1.2	1.6	1.8	5.9	6.5
Total	100	100	100	100	100
US \$ billion	31.5	54.8	114,5	311.3	560.4

SOURCE: Singapore Department of Statistics: <https://data.gov.sg/>

The data relating to the evolving patterns of outward FDI from Singapore seems to suggest that, even with required broader reforms, opportunities for Sri Lanka to attract Singaporean investors are not very promising (Table 4). This is because there is limited compatibility between the sectoral composition of Singaporean outward FDI and both Sri Lanka's development priorities and the current stage of economic development. Over a half of outward FDI from Singapore is in the financial sector. These investments are primarily destined to high-income countries. The manufacturing share of FDI, which is relevant for Sri Lanka's objective of joining global production networks, accounts for a smaller and declining share of total outward FDI (16% in 2015-16, compared to 25% in 1994-95). MNEs accounts for the lion's share of Singapore's manufacturing industry (over 80% output). As noted, the SLSFTA is unlikely to be relevant for these MNEs because they make investment location decisions at their headquarters based of a wider inter-country assessment.

Concluding remarks

The role of FTAs in trade expansion is vastly exaggerated in the Sri Lankan policy debate.

Most politicians, and much of the media, often do not seem understand the distinction between 'free trade' and 'trade under FTAs'. FTAs are essentially preferential trade deals the actual trade effect of which is conditioned by the choice of commodity coverage, which is basically determined by political considerations and lobby group pressure, and the rules of origin.

The failure to make progress with the process of multilateral liberalization under the WTO does not make a valid case for giving priority to FTAs. The proliferation of FTAs over the past three decades has been driven largely by several non-economic factors, including the bandwagon effects. If the road to multilateral approach to trade reforms is closed, then the better and time-honored alternative is unilateral liberalization combined with appropriate supply-side reforms.

Notwithstanding the proliferation of FTAs, the actual coverage of these agreements in world trade is much lower than that portrayed in the Sri Lankan debate. Over 80% of world trade still takes place under the standard most favored nation (MFN) tariff system. The outcome of FTAs or unilateral liberalization depends crucially on supply-side reforms needed to improve firms' capability to reap gains from market opening. However, even with effective supply-side reforms, FTAs would not promote trade in the absence of significant compatibility in trade patterns of the partner countries. Trade compatibility depends on the nature of economic structures and the stage of development of the countries. Location of the countries in the same region (the 'neighborhood' factor) does not necessarily ensure trade compatibility. Our estimates of trade compatibility and the analysis of the experience under the SLIFTA and SLPFTA cast doubt on potential trade gains from signing FTAs with countries in the region.

Giving priority to FTA as the national trade and development strategy is not consistent with the government's objective of linking domestic manufacturing to global production networks (global manufacturing value chain). Global production sharing is a global, not necessarily a regional phenomenon. The relative cost advantage of producing/assembling a given part or components in the supply chain need not necessarily lie in a country within the jurisdictional boundaries of a specific FTA. There is no evidence to support the view that Sri Lanka needs an 'intermediary' country (Singapore) to join production networks. The electronics firms currently operating in Sri Lankan manufacturing export predominantly to countries like Japan, USA, Germany and some European countries. Their exports to Singapore and other ASEAN countries are minuscule, notwithstanding duty free access to these markets under the WTO's Information Technology Agreement.

Proliferation of FTAs has the adverse side effect of diverting government attention from other development prerequisites. Overlapping of the standard MFN tariffs with FTA tariff concessions and multiple RoOs attached FTAs weaken efficiency improvements in the custom system, and opens opportunities for corruption.

The available evidence on the role of FTAs in attracting FDI is mixed, at best. The only policy inference one can make from this evidence is that FTAs can play a role at the margin in enticing foreign investors, provided the other preconditions on the supply side are met.

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