Chapter 28
ISFTA: Lessons for Bangladesh

Kumar Gaurav, Nalin Bharti, and Priyanka Sinha

Abstract Global financial crisis has offered many lessons for the developing economies. Regional trade network in South Asia is weak compared to many other regional trading blocs of the world. It is the size of the domestic markets that matter especially at the time of crisis. Trade theorist Michael Porter pioneered that the competitive advantage of nations is created and sustained through a highly localized process: the nature of home market demand for industry's product or service. In the aftermath of the financial crisis, countries need to expand the size of its domestic market with more regional economic integration. Economic integration does provide the solution to enhance and enlarge the size of the domestic markets; like in case of the European Union (EU), economies associated with EU operate as a domestic market. Similar benefits can be attributed in the case of bilateral Free Trade Agreements (FTAs) in South Asian Association for Regional Cooperation (SAARC) region or at the level of South Asian Free Trade Area (SAFTA). This will assist and facilitate economies to recover by means of engaging themselves in regional trading agreements. The recent Revised Sensitive Lists under SAFTA (Phase II) announced on January 1, 2012, by India, Sri Lanka, and Bangladesh is examined here with a special attention to the India-Sri Lanka Free Trade Agreement (ISFTA). In the current context of ongoing negotiations on Bangladesh-Sri Lanka and Indo-Bangladesh bilateral FTA, paper advocates for the gains in reducing sensitive list because it gives fresh impetus in terms of providing new technology, expansion of the international markets, and new opportunities for investment. The local business entrepreneurs in Bangladesh raise the fear of losing local industry and agro-activities, but Bangladesh may also realize the intra-SAARC trade, differently. Instead of trade competition, Bangladesh may look for intra-industry/intra-business compliments as is evident in the case of ISFTA. Sensitive lists are one of the prime reasons for the slow speed of SAFTA and other respective bilateral FTAs. The prime hypothesis of this paper is around the argument that the bilateral FTAs in South Asia are going to move SAFTA ahead which leads to more trade and investment even in the post-financial crisis-damaged markets. The paper adds new dimension in the

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field of South Asian economic integration through examining how boosting trade and investment are linked with the bilateral FTA. It may also pave the ways for Bangladesh to enter into bilateral FTAs with India and Sri Lanka.

Keywords ISFTA • Competitive advantage • SAARC • Bilateral FTA • SAFTA • Sensitive list, Economic integration

1 Introduction

The free trade debate dates back to the times of the founding father of economics, Adam Smith. In his monumental work, *The Wealth of Nations*, he argued in favor of laissez faire policy. This was perhaps the beginning of free trade doctrine. Adam Smith has propounded the absolute advantage theory of international free trade. David Ricardo also favored the policy of free trade through his comparative advantage principle of international trade. A more advanced version of comparative advantage theory of trade is the Heckscher-Ohlin model. Thus, the rationale for free trade is more than two centuries old. Free trade is a policy whereby the government does not intervene in trading between nations by tariff, quotas, or other means (Samuelson and Nordhaus 2007). Free trade allows the maximization of world's output, thus making it possible to increase the consumption basket of consumers than without free trade. There are dynamic gains from free trade. Bhagwati (2002) has stated that Smith-Ricardo analysis of gains from trade via specialization and the associated case for free trade was to win approval since the beginning. Countries impose trade barriers in the forms of tariff and nontariff on different grounds to restrict the free flow of international trade. Import tariff has become the most vibrant means of trade policy instruments. Besides tariffs, nontariff barriers like quota, domestic content requirements, export subsidies, antidumping regulations, and other government policies have also been used in order to restrict free trade. The efficiency case of free trade states that trade restrictions in form of a tariff leads to production and consumption distortions. The cost-benefit analysis provides the theoretical grounds for free trade. Consumer and producer surplus forms the basis for costs and benefits.

Free trade with the imposition of tariff on a country's import has three effects: firstly, reduction in the imports and consumptions; secondly, increase in the domestic price and production of a commodity; and finally, increase in tariff revenue to the government. After imposition of tariff, import reduced from GF to HI and consumers surplus also decreased as in Fig. 28.1. The tariff raises the price in the domestic markets from 0P to 0P2 and domestic production increases from 0Q2 to 0Q2′. Government now receives tariff revenue equal to the area KJIH.

New advancement in trade theory emphasizes on the competitiveness of the domestic markets. It can be found in the works of trade theorist Michael Porter. He pioneered the national competitive advantage theory of trade in the 1990s. The theory of competitive advantage rests on four factors called as the diamond of

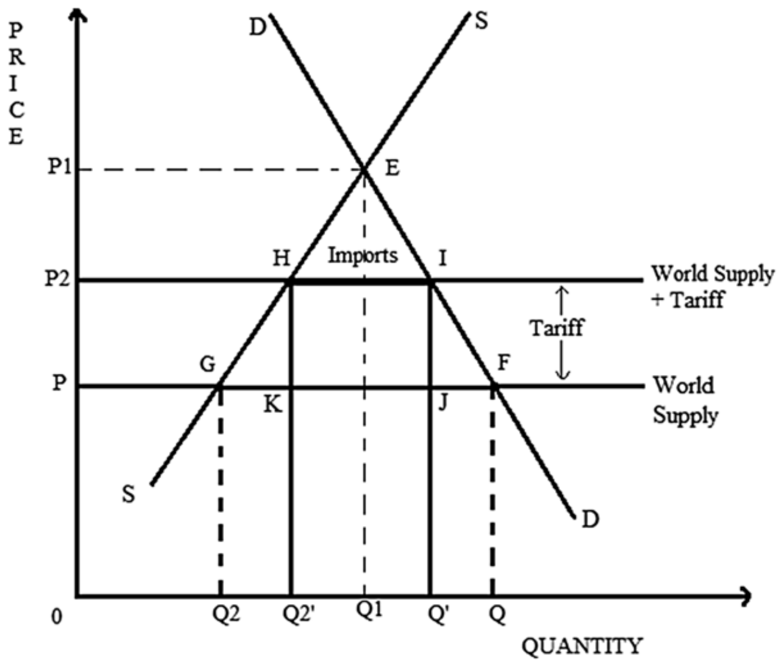

Fig. 28.1 Effect of tariff in a free trading economy

national advantage. These are factor conditions, demand conditions, related and supporting industries, and firm strategy, structure, and rivalry. According to Porter (1990), a nation's competitiveness depends on the capacity of its industry to innovate and upgrade, and it not merely depends on natural endowments, its labor pool, its interest rates, or its currency's value. Countries benefit from having strong domestic rivals, aggressive home-based suppliers, and demand from domestic consumers. Competitive advantage is created and sustained through highly localized process. The need for a strong domestic market is attributed to sustain the economies, especially at the times of crisis. Global financial crisis has offered many lessons for the developing economies in recent past. Regional trade network offers a strong case for enhancing and enlarging the size of the domestic markets. Regional trading agreements (RTAs) can be seen as a strong case for liberalization of the world trade. There are basically three forms of trade liberalization: unilateral, bilateral, and multilateral. When countries remove their trade barriers without waiting for other countries, it signifies unilateral trade liberalization. Unilateral trade liberalization promotes country's competitiveness in the world's markets and encourages comparative advantage. The other involves the reciprocal reduction of trade barriers on a nondiscriminatory basis, as seen in the operation of World Trade Organization (WTO). Finally, the bilateral (or plurilateral) route manifests itself in what economists have come to call preferential trade agreements (PTAs). In the case of PTAs, two or more countries reciprocally liberalize trade with each other but not to the rest of the world. The process of bilateral or plurilateral reductions in trade barriers among the member countries is commonly known as the process of economic integration. It is the process of eliminating restrictions on trade. It results in the uniting of two or more national economies in a regional trading arrangement (Carbaugh 2008).

Economic integration commences with signing a preferential trade agreement (PTA). It is the first stage of economic integration which gives preferential access to certain products from the participating countries. A PTA is followed by the free trade area (FTA) and is an association of trading nations in which members agree to remove all tariff and nontariff barriers among themselves. Each member, however, maintains its own set of trade restrictions against outsiders. Like a free trade area, a customs union is an agreement among two or more trading partners to remove all tariff and nontariff trade barriers among themselves. In addition to this, all member nations impose identical trade restrictions in terms of common external trade policy against nonparticipants. The next stage of economic integration is common market. It is a group of trading nations that comprises all the features of a customs union. Besides this, it ensures free movement of factors of production across national borders within the economic bloc. The next stage is the economic union in which national, fiscal, taxation, and social policies are harmonized and governed by a unified institution. The final stage may be the monetary union in which national monetary policies and the acceptance of a common currency governed by a supranational monetary authority takes place.

Viner (1950) introduced the concepts of trade creation and trade diversion which provide the theoretical grounds and rationale for the creation of PTAs. Trade creation is the replacing of relatively high-cost domestic production with lower cost imports from the partner country. Trade diversion takes place when a country switches its source of imports from a more efficiently producing country to a less efficiently producing country. Efficiency gains are captured through the trade creation and efficiency losses through trade diversion in the case of free trade areas and other forms of economic integration. A regional trading bloc enlarges the size of domestic market. The entire bloc serves as a domestic market. Like in case of the European Union, the whole EU is like a domestic market. It is argued that trade liberalization and regional economic integration can help a region increase its intra-regional trade by exploring the size of the market. This may in turn yield efficiency and bring benefits not only by exploration of economies of scale but also by dynamic and upward shifts in production function (Ali and Talukder 2009).

2 Economic Rationale for Free Trade Agreements

Free trade agreement is a form of preferential trading agreement (PTA) which provides the second-best option, the first being the multilateral trade liberalization as is evident in the operation of the WTO. It is worth to mention that regional trade agreements can complement the free trade process but cannot replace multilateral liberalization (OECD Policy Brief 2003). The theory of second-best proposes that given a distorted system, eliminating one of the distortions does not ensure a better-off overall economic welfare as long as distortions remain unchanged (Plummer et al. 2010). There are static and dynamic effects of an FTA. Jacob Viner provided the theoretical analysis for the assessment of customs union which was extended to analyze an FTA through the theory of trade creation and trade diversion. It is the partial equilibrium model that analyzes the potential effects of an FTA. It is worth to note that welfare changes by the formation of an FTA are the sum of changes in producer and consumer surplus and the government revenue due to tariffs (World Bank 2006). Conventional wisdom argues for the improvement in the welfare because these agreements include a degree of trade liberalization. Viner showed that an FTA can adversely affect the welfare of a country. The major drawback of Vinerian model is that it takes into account the market for just one good ignoring any interaction with multiple goods market. Plummer et al. (2010) assert that one of the departures from this model is the general equilibrium model based on the works of Meade (1955), Lipsey (1970), and Wonnacott and Wonnacott (1981). There are limitations in these models. To overcome these limitations, computable general equilibrium (CGE) and gravity models are used to evaluate the effects of an FTA. General equilibrium analysis provides the sound ground for policy implications as it takes into account the interactions between the markets. To analyze the economic effects of multilateral and bilateral trade agreements, the CGE modeling framework of Global Trade Analysis Project (GTAP) provides one of the best tools of analysis (Sikdar and Nag 2011). On the other side, gravity model is useful in the analysis because it provides better explanation in real-world situations. Dynamic effects of FTAs include scale economies, technology transfer, structural policy reforms, and competitiveness and growth effects.

The latter half of the 1980s to the early 1990s witnessed an explosion of regional trade agreements (RTAs) in the global economy (Weerakoon 2001a). Likewise there arises a need for the countries in the south Asia to form a regional trading bloc to foster the process of economic integration in this region. The establishment of the South Asian Association for Regional Cooperation (SAARC) on December 8, 1985, marked the beginning of economic cooperation in South Asia. In accordance with the sixth SAARC summit, SAARC Preferential Trading Arrangement (SAPTA) was signed on April 11, 1993, much ahead as was agreed and it become functional from December 7, 1995. Article 2 of SAPTA emphasizes on the broad commitments for the promotion of trade in multilateral framework among the member countries. Article 10 of SAPTA grants preferential treatment to LDCs in tariffs, free access to member's market, removal of nontariff barriers, limited removal of para-tariffs, and others. In the year 2004, SAARC took a leap forward when it signed South Asian Free Trade Area (SAFTA). It became operational in the year 2006 (January 1) with broader objectives of facilitation of trade by elimination of trade barriers in a phased-wise manner. It emphasized on enhancing trade in South Asia and economic integration for mutual benefits. As a part of achieving such goal of SAFTA, it was realized to liberalize trade policy through various reforms. Sensitive list is one of the major issues in trade liberalization and policy reforms in South Asia.

3 Trade Policy Reforms in Sri Lanka, Bangladesh, and India

Export promotion (EP) an outward looking development policy was adopted by Sri Lanka to attract foreign investments. Unilateral trade liberalization process was initiated in 1977 in Sri Lanka which makes it unique in South Asia as it started its reforms early than any other country in this region. The policies included import liberalization, relaxation of exchange controls, facilitating foreign direct investments, and private sector-driven economic strategies.

Bangladesh which lies in close proximity with India started opening its economy in the 1980s but was marked by limited progress, and its scope was also of limited extent. It further started the reform process when it engrossed a deeper and enlarged spectrum of reforms in trade policy in the early 1990s. To cater the needs for rapid and sustained growth and development of the country, Bangladesh reduced its tariffs substantially and rationalized tariff rates to bring about harmonization in tune with other South Asian economies. Further reduction and removal of quantitative restrictions were incorporated. Bangladesh moved from multiple systems of exchange rates to a unification of exchange rates in conformity with world economies. Current account was made convertible as a part of export promotion outward-oriented trade regime. The trade to GDP ratio increased to 18 % in 1990 to 43 % in 2008 (World Bank 2013), as result of these initiated policy measures. Further this ratio increased to 50.4 % on an average in 2009–2011. Bangladesh which was traditionally known for its primary products exports like jute and tea is now well known for ready-made garments (RMG) sector and leather products (Harun 2010). Due to heavy agricultural and nonagricultural import tariff, Bangladesh is still marked as one of the least liberalized regimes in trade policy in the world.

India's trade policy after independence was restrictive for many years after independence. It was reflected in restrictive import policy during period 1947–1952. During 1952–1953 to 1956–1957, liberalization of foreign trade was adopted through liberalizing the import licenses. A very restrictive import policy was adopted from 1956–1957 to June 1966, and the import controls further screened the list of imported goods. To check imports and to boost exports, the government of India undertook devaluation of the rupee in 1966 as a major step. Trade policy was quite successful during fourth plan in restricting imports and promoting exports. This period continued till 1975–1976. During Janata rule (1977–1979), import liberalization was also adopted to augment domestic supply of essential goods and to check rise in price level (Tendulkar and Bhavani 2007).

India embarked on the path of industrial, financial, and external sector reforms in the 1990s which were initiated creating an environment conducive for the expansion of trade (Reserve Bank of India 2003). Trade policy (1991) aimed to reduce administrative controls and barriers which acted as obstacles to the free flow of exports and imports. The basic instrument developed by the policy was the Exim scrip in place Rep licenses. The purpose of this instrument was to permit imports to the extent of 30 % on 100 % realization of export proceeds. Obviously, the purpose was to bridge the BOP gap.

4 Tariff Reduction: India, Bangladesh, and Sri Lanka

WTO explains most favored nation (MFN) tariffs as the normal nondiscriminatory tariff charged on imports. It excludes preferential tariffs under free trade agreements and other schemes or tariffs charged inside quotas. Figure 28.2 shows the average MFN applied tariff rates (unweighted) by India, Bangladesh, and Sri Lanka during 1990–2009. India has 81.8 % tariff rate in 1990, declined rapidly after the economic reforms. In 1991 it stood at 79.2 % and declined to 53 % in 1992. Further in the year 2009, it declined and remained at 10.1 %. Bangladesh on the other hand underwent reforms in the early 1990s. In 1990 average MFN applied tariff rates stood at 94 % and declined to 88.6 % in 1991. In 2008 it stood at 14.8 %. Sri Lanka which is marked by one of the most liberalized economies in South Asia had tariff rate of 28.3 % in 1990. It is the lowest compared to these three economies. In 1992 the tariff rate was at 26.9 % which further declined to 10.1 % in 2009. Thus, the data on average MFN applied tariff rates in these three countries shows a declining trend. Of these three South Asian countries, Bangladesh still remains less liberalized compared to other two countries.

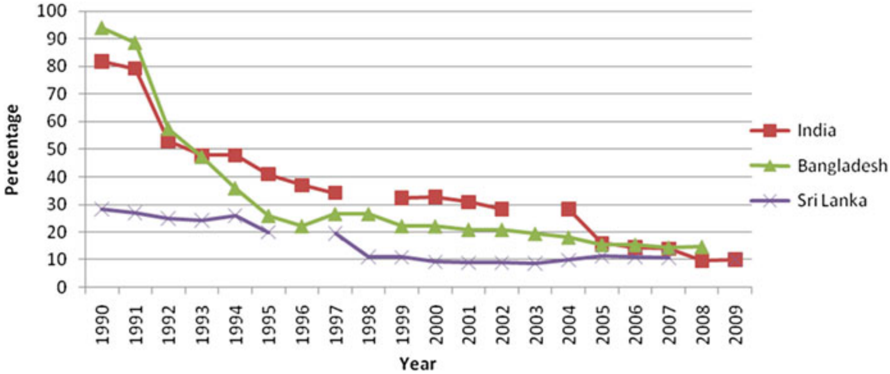

Fig. 28.2 Trends in average MFN applied tariff rates in India-Bangladesh-Sri Lanka (Source: Compiled by Authors from World Bank (2010))

5 India-Sri Lanka Free Trade Agreement (ISFTA)

India and Sri Lanka envisage at establishing a free trade area in accordance with the provisions of the ISFTA and in conformity with relevant provisions of the General Agreement on Tariff and Trade (GATT), 1994 (Article 1 of ISFTA). The ISFTA was signed on December 28, 1998, to promote mutually beneficial bilateral trade. The agreement came into effect on March 2000. It contains different articles and several annexures. Article 1 defines the broad objectives of the agreement. Annexure A of this agreement describes the concessions offered by India and phaseout schedule for elimination of tariffs in 3 years from ISFTA being effective. Concession offered by Sri Lanka is mentioned in Annexure B of India-Sri Lanka Free Trade Agreement. It provides tariff concessions on exports from India in respect of items freely importable into Sri Lanka and phaseout schedule for elimination of tariffs in 8 years time framework from ISFTA being effective. According to ISFTA, a wide range of products are granted free access to exports from these countries. But it also contains list of items which are restricted between these two countries for bilateral trade in Annexure D of the ISFTA. The agreement contains so-called negative list (sensitive list) intended to protect their respective national interests. Additionally, Rules of Origin (ROO) were introduced into the agreement to ensure minimal national content of traded products.

6 The Issue of Reducing Ne gative List

Maintaining respective negative lists does exist in the bilateral or multilateral FTAs. There have been multiple criteria for preparing and maintaining these lists. The major part of these lists includes agricultural products for food security. Along with the most important element of negative list, others like small-scale manufacturing products and noncompetitive domestic industries are also protected in form of inclusion in the list. "There are two distinct features of India-Sri Lanka trade, namely a low volume of bilateral trade and a persistent balance of trade in favor of India" (Weerakoon 2001b). Taneja et al. (2011) have provided an approach and economic rationale to policymakers for pruning the negative lists maintained by India for SAARC countries. There are several other commodities which seem no rationale to be in the negative lists of these countries. These unnecessary items should definitely be removed from the list. The approach of SAFTA is the negative list maintained by all the eight members of this agreement. India is the largest country among the SAARC members in terms of both geographical area and in terms of GDP. India has reduced its items in the negative list for LDCs to only 25 items and 614 items for non-LDCs. It reflects its commitment under the SAFTA. Other contracting states of this agreement have huge respective negative lists. One of the hypotheses for SAFTA being not so effective is the existing negative list. The table that follows gives a quick recap of respective sensitive lists under SAFTA and ISFTA.

Table 28.1 shows the volume of negative list among three of the SAARC countries. As can be seen Table 28.1, items in India's negative list for non-LDCs are 614 which

Table 28.1 Distribution of items in negative list

Sr. no	Description	No. of items (under SAFTA)[a]				No. of items and % share (ISFTA)[b]			
		Bangladesh (for NLDCs)	India (for LDCs)	Sri Lanka[b]	India (for NLDCs)	India		Sri Lanka	
		Column 1	Column 2	Column 3	Column 4	No. of items	% share	No. of items	% share
1.	Live animals, animal products	19	0	90	28	0	–	160	13.11
2.	Vegetable products	31	0	204	38	2	0.46	227	18.61
3.	Animal or vegetable fats and oils	3	0	37	21	0	–	40	3.28
4.	Prepared foodstuffs, beverages, tobacco	71	25	165	57	17	3.95	176	14.43
5.	Mineral products	10	0	22	5	0	–	23	1.89
6.	Chemical products or allied	51	0	22	36	0	–	32	2.62
7.	Plastics and rubber	49	0	84	97	100	23.20	86	7.05
8.	Leather products	12	0	25	0	0	–	16	1.31
9.	Wood products	6	0	2	11	5	1.16	5	0.41
10.	Paper products	44	0	49	14	12	2.78	66	5.41
11.	Textile and textile articles	364	0	20	182	295	68.45	20	1.64
12.	Footwear and others	13	0	30	17	0	–	32	2.62
13.	Stone, plaster, cement, ceramic, glass, and glassware	26	0	36	10	0	–	39	3.20
14.	Pearls, precious stones, precious metals	1	0	3	0	0	–	3	0.25
15.	Base metals and articles	89	0	114	60	0	–	113	9.26
16.	Machinery and mechanical appliances, electrical equipment	84	0	69	28	0	–	81	6.64
17.	Vehicles, transport equipment	41	0	37	4	0	–	43	3.52
18.	Optical, photographic equipment	22	0	7	2	0	–	8	0.66
19.	Arms and ammunition	0	0	0	0	0	–	0	–
20.	Misc. manufactured articles	57	0	49	4	0	–	50	4.09
21.	Works of art, antiques	0	0	0	0	0	–	0	–
	Total	993	25	1,065	614	431	100	1,220	100

[a]Source: Compiled from SAARC's Revised Sensitive Lists under SAFTA (Phase 2)
[b]Source: Compiled by authors from Department of Commerce, Sri Lanka

Table 28.2 Results from compression at bilateral level

Bangladesh-India	Sri Lanka-India	Bangladesh-Sri Lanka
Column 1–2	Column 3–4	Column 1–3
India has only 25 items, but Bangladesh has 993 items in the negative list	It suggests that being NLDCs (both India and Sri Lanka), they would have to trade on the basis of SAFTA's respective negative lists	There are 993 sensitive items on Bangladesh side, whereas 1,065 from Sri Lankan side
The common products are in the prepared foodstuffs, beverages, and tobacco items only	But the trade between these two countries is governed on the basis of ISFTA and SAFTA	The common items are huge between these two countries
Bangladesh largely protects its textile sector	These lists suggest that vegetable products of Sri Lanka and textile sector of India are heavily protected	Large volume of common items are in the prepared foodstuffs, plastics and rubber, paper products, base metals, vehicles and transport equipment, misc. manufactured articles
Other sectors which are largely protected by Bangladesh are prepared foodstuffs, base metals, machinery and mechanical appliances, chemical products, and plastics and rubber products	Other common items seems to be live animals category, animal or vegetable fats and oils, prepared foodstuffs, chemical products, plastics and rubber, base metals, machinery and mechanical appliances, etc.	Other common items of significance are live animals and animal product, vegetable products, chemical products, leather items, textiles, footwear, and stone and ceramic items
Thus, India is unilaterally providing opportunities for exports for LDCs like Bangladesh under SAFTA	Thus, both the countries are benefitting from FTA. India being asymmetrical in terms of volume of world trade, it is providing more opportunities to Sri Lanka (lesser items in negative list than Sri Lanka)	Thus, both the countries maintain huge negative list which reduces the opportunities for bilateral trade under SAFTA framework

Source: Authors. Based on the available data in Table 28.1

will be applicable to Sri-Lanka, but due to ISFTA, the operational list includes only 431 items. The negative list of Sri Lanka for India included 906 items under SAFTA, but ISFTA includes 1,220 items. Thus, India on the one hand restricts lesser items, while Sri Lanka maintains not only huge negative list but also maintains bigger list than SAFTA. India thus provides unilateral benefits to Sri Lanka. The list hinders the trade and investment, and thus the South Asian region remains insignificant as far as share in global trade is concerned. During the period from the year 1995 to 2005, the share in world trade of this region increased marginally from 0.9 to 1.2 %. The limited product coverage and the existence of huge negative list effectively reduce the scope of intra-regional trade in South Asia. It has been estimated that almost 53 % of the total import trade in SAFTA has been subject to the negative list of the respective countries (Weerakoon and Thennakoon 2006). The negative list thus significantly limits the scope of the SAFTA. In India-Sri Lanka Free Trade Agreement (ISFTA), each country maintains its negative list. Out of 431 items in Indian side and 1,220 from Sri Lankan side, the number and % share have been shown in Table 28.1. Table 28.2 presents the summary of the data presented in Table 28.1.

7 Trade-Investment Linkages: Benefits from ISFTA

There is a need to recognize the strong trade-investment linkages in South Asia. These links provide the rationale for achieving higher levels of intra-regional trade in regional trading blocs. Trade-creating joint ventures thus become crucial not only because it renders export potentialities of the countries in the regional blocs but also because it enlarges the size of the markets. They also help in creation of employment at mass level by leveraging the productive capacity. An FTA provides avenues for joint ventures to seek the benefits of foreign capital and investment inflows. The trade-creating joint ventures are in a position to take advantage of the regional FTA as in the case of ISFTA. Such agreements can also induce investment flows both between the countries of the bloc and from outside the region (Taneja and Sawhney 2007). The South Asian region is characterized by large asymmetries in terms of their size and GDP. Trade allows smaller countries in this region to specialize and produce a few products at high enough levels of output to reap the economies of scale. Trade and investment integration in the South Asian region is far below its potential due to several policy-induced factors like lack of adequate treatment of nontariff barriers, among others, as well as structural factors like infrastructural bottlenecks and restraints on factor mobility in the region (Dubey 2007). This manifests the need for increasing economic integration in this region.

7.1 *Investments and Joint Ventures (JVs)*

India has been a major player in terms of investments to Sri Lanka (see Fig. 28.3 for more details). Sri Lankan economy has attracted foreign investments in multiple areas including retail to tourism and petroleum, financial sectors including banking, telecommunications, food processing, vanaspati, cement, copper, tire, glass industry, hospitality, and real estate. Indian investment in Sri Lanka reached a total of US$600 million, making it number four in the world (Doing Business in Sri Lanka 2012).

7.2 *Lanka Ashok Leyland*

JV investment in Sri Lanka by an Indian company (Ashok Leyland) is Lanka Ashok Leyland in 1982 which has started its production from 1983. This venture is having the objective of reaping the benefits from the expansion of markets locally and further development of ancillary industries domestically.

7.3 *Ceat-Kelani*

Sri Lankan economy has the benefits as it underwent three-way venture with AMW, Ceat Tyres India, and Kelani Tyres Sri Lanka in 1999. This venture aims to fulfill the twin goals of low-cost manufacturing and larger market access in this island nation.

The venture resulted in Ceat-Kelani Associated Holdings Pvt. Ltd. which is the largest domestic tire manufacturing company in Sri Lanka. According to Mel (2011), this joint venture started operations with one plant in Kalutara. Today it has three plants with a radial tire plant established in 2006. The technology and management inputs are sourced from India. The venture manufactures a varied range of tires for all modes of transport such as light trucks, buses, trucks, vans, cars, motorcycles, and three wheelers as well. The high manufacturing cost was contained after it joined the hands with Indian tire manufacturing giant Ceat. As a result, the average annual production increased manifold as compared to previous production. It stood at 12,800 metric tons currently and was 7,400 metric tons during 1999–2002. With increased production and productivity as a result of investments in technology, the JV now exports to many Asian and European countries including Dubai, Nigeria, and Egypt. The JV also exports to India under ISFTA. It is claimed that economies of scale in tire manufacturing sector in Sri Lanka has brought the cost below the levels of Ceat's plant in India.

7.4 L&T Infrastructure and UltraTech Cement

A joint venture between L&T and National Housing Board of Sri Lanka was concluded to develop the Iconic Diamond Tower Project of Sri Lanka. The land has been secured and required permissions from the Colombo Municipal Corporation have been finalized. Apart from that, UltraTech Cement plant has also been started in Sri Lanka. The current turnover has been $US59 million which is expected to almost double in the coming years.

7.5 Telecommunications

Bharti Airtel Lanka is a subsidiary of Indian Telecom giant Bharti Airtel. It started its commercial operations in Sri Lanka from 2009 and now has distinctive feature of the fastest growing wireless operator in the island nation. Apart from that, Tata Communications Lanka Limited becomes operational in Sri Lanka in 2004. It was able to obtain an External Gateway Operator License in 2003. These provide the global telecommunications needed by the Sri Lankan customers.

Apart from these JVs and investments, many other Indian companies have started investing in Sri Lanka. Indian Oil Corporation (IOC), Taj Hotels, Asian Paints, J.V. Gokal Ceylon Pvt. Limited, Tata Housing, Piramal Glass Ceylon, ITC, and banks like State Bank of India (SBI), ICICI, Indian Bank, Indian Overseas Bank, and Axis Bank are some important investors (Doing Business in Sri Lanka 2012).

7.6 Tourism

Tourism has been an important sector and crucial for foreign exchange earnings for Sri Lanka. Total number of tourists who visited Sri Lanka in 2012 and 2013 was 1,005,605 and 1,274,593, respectively. India accounted for the highest number of tourists' arrival in Sri Lanka. Total number of tourists from India who visited Sri Lanka in 2012 was 176,340 which increased to 208,795 in 2013, a rise of 18.4 % in just 1 year (Sri Lanka Tourism Development Authority 2013). Sri Lanka also is in the top ten countries from where tourist arrivals are registered in India. It stood at fourth position in terms of tourists' arrival in India. In 2009, 2010, and 2011, a total of 239,995 and 266,515 and 305,853 Sri Lankan tourists visited India (Ministry of Tourism 2012). Thus, tourism has become an important area for cooperation between India and Sri Lanka.

8 Lessons for Bangladesh

The potential benefit of an FTA is the large trade creation by shifting manufacturing from high-cost domestic production to low-cost imports from the member country. The India-Sri Lanka Free Trade Agreement (ISFTA) has generated many possibilities and has potential to boost bilateral trade and investments in the South Asian region. Sri Lanka has benefitted a lot in terms of Indian investments and able to explore Indian technology, expanded its markets locally and globally, and explored opportunities for investment in many areas in the form of mutual cooperation and joint ventures (JVs). Sri Lanka has reaped the benefits of low-cost manufacturing in the tire segment and also able to push up labor productivity. This has initiated rising production and brought down the cost of converting raw material to finished products in the manufacturing JVs. Similarly Bangladesh can avail similar and even more benefits (geographical proximity) if it undergoes FTA with India. In the same way, Bangladesh can be benefitted after signing FTA with Sri Lanka.

Bangladesh has comparative advantage in the ready-made garments (RMG), leather, and footwear manufacturing sector. India and Sri Lanka on the other hand may take the advantage of cheap labor in garments sector and leather and footwear by collaborating with Bangladeshi companies through joint ventures. These countries can also avail benefits in the area of oil and gas exploration and in pharmaceuticals and shipbuilding industry as Bangladesh has comparative advantage in shipbuilding. Other potentials in Bangladesh are cooking gas distribution and power stations construction.

Bangladesh is one of the prime destinations for Indian investors. The free trade regime will attract more FDI from India in Bangladesh due to certain key factors such as easier access to India's north eastern region, on the one hand, and abundant availability of low-cost labor as a major incentive for setting up of manufacturing plants, on the other. The main areas where investments will have to flow are energy and power, transportation, urban infrastructure, border infrastructure, information, communication and technology, warehousing and cold storage facilities, education services and skill development, etc. Some recent investments in Bangladesh from India are highlighted as follows:

- A deal of US$1.5 billion has been signed by Indian power sector giant NTPC with Bangladesh in order to build coal-based plant with a capacity of 1,320 MW to generate electricity. This will be Bangladesh's biggest power project aimed at fulfilling the needs of power shortages in Bangladesh. 250 MW power will be exported to Bangladesh.
- US$300 million has been invested by Indian telecom operator Bharti Airtel in Warid Telecom of Bangladesh in a view to expand the domestic operations. It has thus become the largest Indian investor in Bangladesh.
- A memorandum of understanding (MoU) has been signed with Nitol-Niloy Group of Bangladesh by India's Tata International Limited for manufacturing of footwear and bicycle. A total of US$15 million has been invested by Tata.
- Meru Cabs of Bangladesh and Tata Motors-Nitol Group underwent a memorandum of intent for investing in radio taxis in January 2010.
- Marico has an advantage to become the first Indian company to be listed in Dhaka Stock Exchange in Bangladesh. Now it announced for its expansion by investing Taka 50–60 crores which will lead to a total investment of Taka 100 crores.
- Bangladesh imports 95 % of its domestic tire requirements. Ceat India has thus announced its interest to invest Rs. 250 crores in a view to set up manufacturing plant in Bangladesh. Sixty five tons per day was expected initial capacity of this plant. It will commence production in FY2013 (Acharya and Marwaha 2012).

The level of FDI from India in proportion to the total FDI in Bangladesh shown in Fig. 28.3 is much lesser than the level of FDI from India in proportion to the total FDI in Sri Lanka. This shows how FTA is a reliable base for more FDI.

The Sri Lanka-Bangladesh current trade and investment relations are also showing many positive indications which may be also presented as follows:

- During last 4–5 years, the bilateral trade between Sri Lanka and Bangladesh has marked an improvement. The trade between these two nations at the level of US$48 million in the year 2010 has seen an increase by 73 % in 2012. It crossed the figure of US$80 million and remained at US$83.19 million (Department of Commerce of Sri Lanka 2012).
- More than US$292 million of Sri Lankan investments by 45 Lankan companies is now in Bangladesh. Bangladeshi investments in Sri Lanka, however, are at a low level of US$3 million (only in six projects) due to restrictions on capital and current investment outflows by Bangladesh side.
- This has limited the full potential of mutual investment development and protection capacity for both countries.

Thus, Bangladesh can be benefitted if it signs an FTA with India and Sri Lanka as well. Huge investments in the form of FDI or through other channels can have positive advantage in many ways. Large industries if established in Bangladesh by India may help Bangladesh develop ancillary industries locally. There is also need for diversification and commercialization of agricultural sector in Bangladesh.

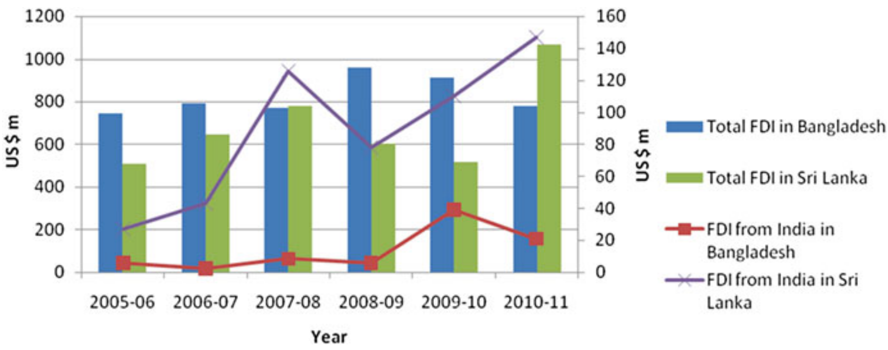

Fig. 28.3 Comparative FDI from India in Sri Lanka and Bangladesh (Source: Compiled by Authors from Acharya and Marwaha (2012) and doing *Business in Sri Lanka*, Handbook for Indian Business (2012), CII)

This sector has potential for the development of agro-based and food processing industries, limited by lack of proper infrastructure. The bottlenecks can be eliminated by reducing negative list and through more regional FDI.

9 Conclusion

ISFTA has generated a strong case for trade creation as is evident from the reduction in the negative list from volume of bilateral trade and investments in the form of joint ventures between India and Sri Lanka. The dynamic gains of an FTA like scale economies, technology transfer, trade and investment policy reforms, and competitiveness have been seen in the case of ISFTA. The scale economies and price competitiveness have been witnessed in the case of Ceat-Kelani and many other industries. India-Sri Lanka FTA has the potential for boosting more economic cooperation. ISFTA offers the conditions for more bilateral FTAs and quick and planned reduction of negative lists. Thus, only the South Asian region has a real, viable, and potential free trade that will ensure benefits as well as development of this region. India-Sri Lanka FTA has the potential for boosting more economic cooperation. It also advocates for similar FTAs with other countries like India-Bangladesh and Sri Lanka-Bangladesh in South Asian region to take the comparative advantage in the form of economic cooperation and investment. The local business entrepreneurs in smaller economies in South Asia raise the fear of losing local industry and agro-activities, but these economies may also think of intra-SAARC trade, differently. Instead of competition, these economies may look for intra-industry/intra-business compliments. Raghavan (1995) also advocates that regional economic cooperation enables the participating countries to exploit the potential of complementarities and also to establish strategic alliances between enterprises with a view to improve their competitiveness in global markets. Furthermore, trade liberalization and regional economic integration can help a region increase intra-regional trade by exploring the size of the market as advocated by the competitive advantage of nations. Competitive advantage is created and sustained through a highly localized process, and nations can be benefitted from having strong and aggressive rivals at the domestic level and also due to strong domestic demand. Countries will thus be protected at the times of crisis due to enlarged domestic markets in the form of regional trading agreements and regional blocs. Countries would succeed only when their domestic business environment is dynamic and outward oriented. Integration is the key to innovate and upgrade in larger domestic setup. This paper may add new dimensions in the field of economic integration through boosting trade and investment. It may also pave the ways for Bangladesh to enter into bilateral FTAs in this region with India and Sri Lanka. Lack of connectivity, geopolitical issues, and asymmetry between countries of the South Asian region are the main obstacles that hindered the economic connectivity in this region. Thus, these obstacles should be removed to capture the full potentialities and expand the size of domestic markets in South Asia.

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