

## **CHAPTER V**

### **CONCLUSION AND RECOMMENDATIONS**

#### **5.1 Introduction**

This chapter presents the conclusion and recommendations based on the estimated results from the GTAP simulation on different trade liberalization scenarios. The impacts of the different trade policy options on the Sri Lankan economy will be determined based on the projected welfare determined by the equivalent variation in the GTAP model. Section 5.2 presents the conclusion of the research. Policy recommendations will be presented for Sri Lanka in section 5.3 based on the projected results to strengthen her trade relationships with the regional trading partners. Section 5.4 illustrates the limitations of the study and recommendations for further study on the South Asian trade liberalization.

#### **5.2 Conclusion**

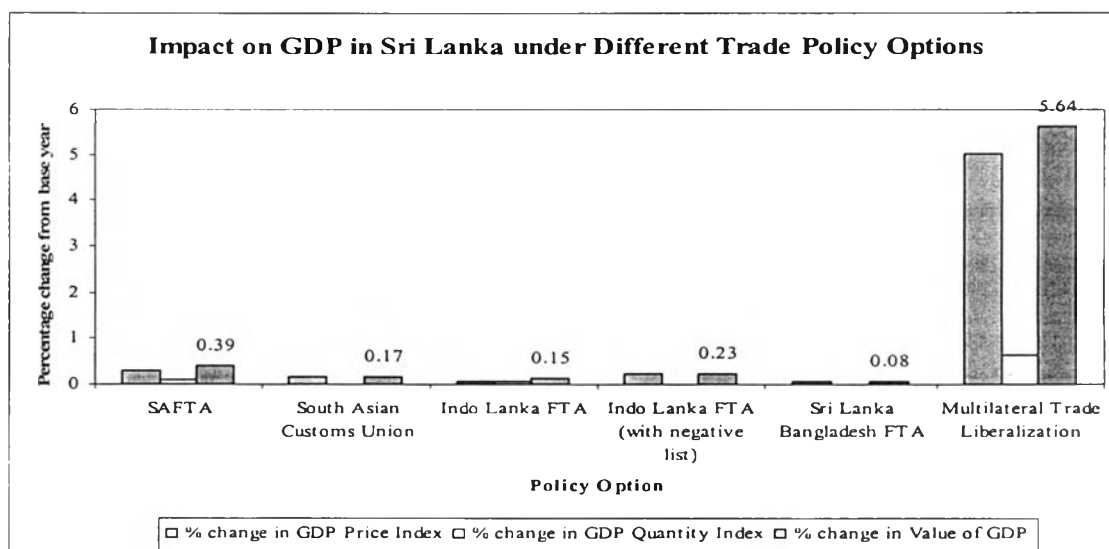
Several important conclusions could be drawn from the analysis of different trade liberalization scenarios in South Asia and its impact on the Sri Lankan economy. Based on the simulation results the impact of welfare variables on the Sri Lankan economy can be presented as follows to determine the best trade policy options for Sri Lanka.

##### **5.2.1 Trade Policy Options for Sri Lanka**

All Sri Lankans are consumers and many are producers, either as businessmen or as employees. Trade policies affect consumers and producers differently and it is important to take a holistic view in judging their effectiveness. Therefore, in deciding the policy options for Sri Lanka it is needed to examine the impact of important macroeconomic variables, welfare and trade.

The below figures illustrate the projected change in GDP, household utility real returns to labour, return on capital and equivalent variation of different trade policy options on the Sri Lankan economy.

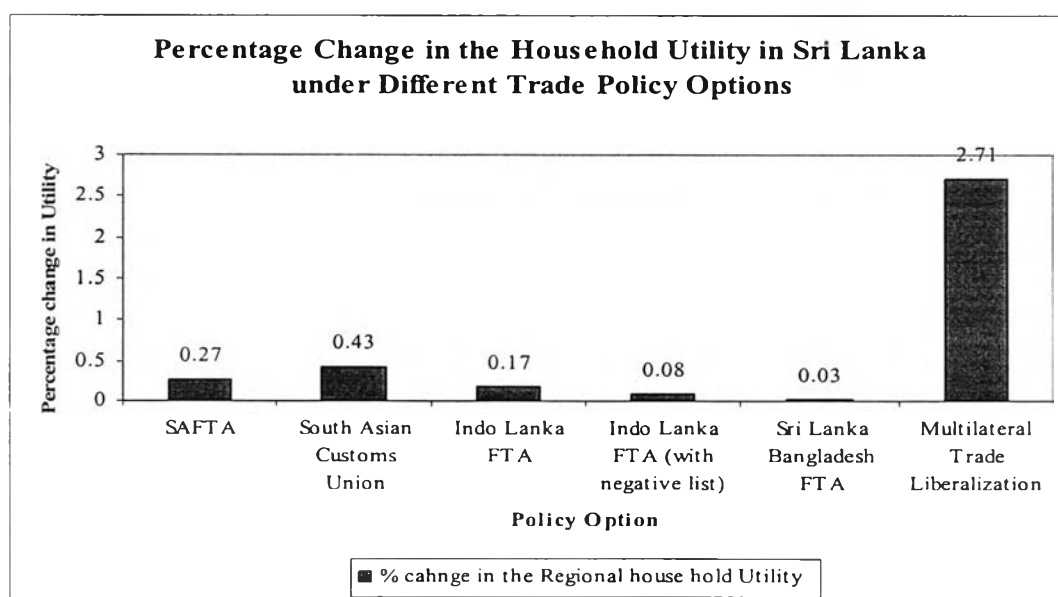
**Figure 5.1 Impact on GDP in Sri Lanka under Different Trade Policy Options**



Source: Simulation results derived from GTAP version 6 (Database 2001)

From the results it can be concluded that the multilateral trade liberalization brings highest improvement to the GDP in Sri Lanka. The second best option is the SAFTA followed by the South Asian Customs Union. Under the bilateral level it can be concluded that Sri Lanka's GDP will increase considerably under the Indo Lanka FTA than under the proposed Sri Lanka-Bangladesh FTA.

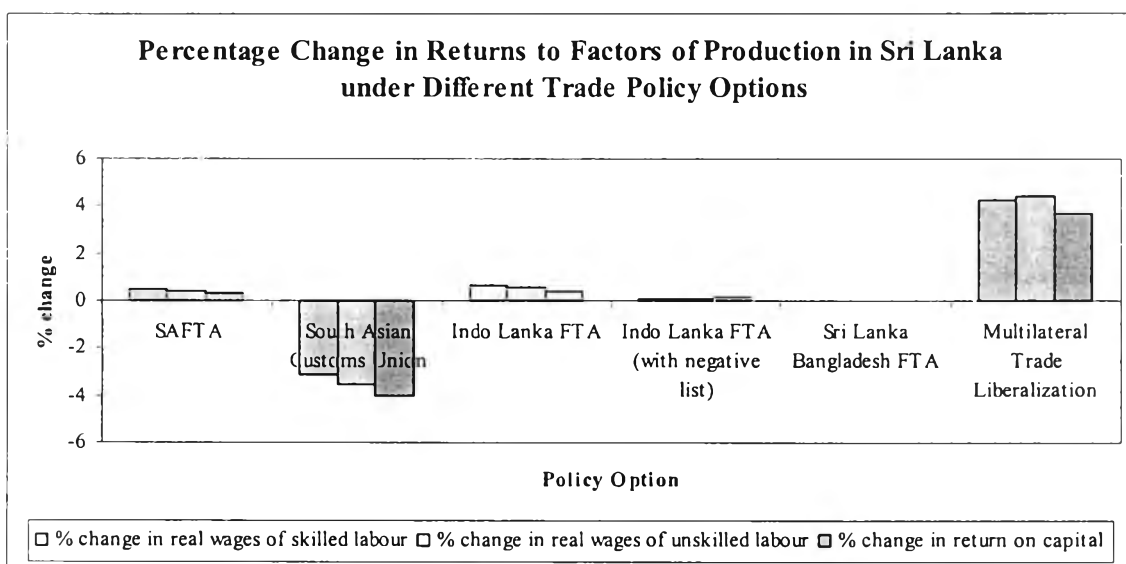
**Figure 5.2 Change in Household Utility in Sri Lanka under Different Trade Policy Options**



Source: Simulation results derived from GTAP version 6 (Database 2001)

From figure 5.2 also it can be concluded that under the multilateral trade liberalization household utility in Sri Lanka will be maximized. Next South Asian Customs Union brings welfare to the households and then SAFTA and bilateral trade agreements follows after the SAFTA.

**Figure 5.3** Change in Returns to Factors of Production in Sri Lanka under Different Trade Policy Options

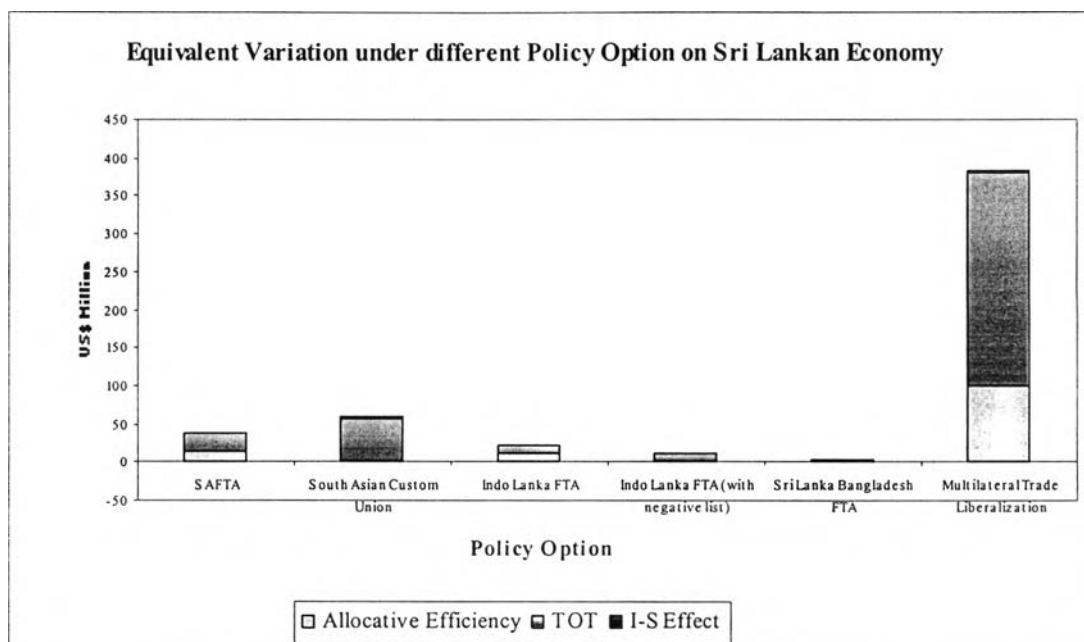


Source: Simulation results derived from GTAP version 6 (Database 2001)

It also can be concluded that return to factors of production are highest under the multilateral trade liberalization. The figure 5.3 shows that under the SAFTA and Indo Lanka FTA real returns to factors of production will improve in Sri Lanka.

The diagram 5.4 below illustrates the estimated equivalent variation under different trade policy options. The EV is an absolute monetary measure of welfare improvement in terms of income that results from the fall in import prices when tariffs are reduced or eliminated. Therefore, in deciding the best policy option, it is important to examine the magnitude of EV under different trade policy options.

**Figure 5.4**                      **Equivalent Variation: Trade Policy Options for the Sri Lankan Economy**



Source: Simulation results derived from GTAP version 6 (Database 2001)

According to estimated equivalent variation it could be revealed that the welfare under the multilateral trade liberalization is much higher than under the other policy scenarios. Then the South Asian Customs Union ensures highest welfare. The SAFTA follows after the South Asian Customs Union and bilateral trade agreements follow after the SAFTA.

Judging by all these impacts on welfare variables it can be concluded that the multilateral trade liberalization is the best policy option for the Sri Lankan economy. This is consistent with the WTO arguments that the multilateral trade liberalization remains the best path to freer trade and development. However, since it takes long time to achieve this, it is argued that trading partners and neighbours will try to advance liberalization through regional and bilateral trade agreements.

From the findings it was revealed that the South Asian Customs Union is the next best policy outcome for the Sri Lankan economy. Further, it was evident that the projected welfare under SAFTA is considerably higher than under the Indo Lanka FTA. Moreover, from the analysis it was found that the estimated welfare is positive for other members of the RTA under the SAFTA. Therefore, it can be concluded that Sri Lanka need to initiate steps to implement the SAFTA with the support of other regional trading

partners. Further, it can be concluded that the present Indo Lanka FTA is also ensures positive welfare to both the Sri Lankan economy and to the Indian economy without seriously harming to the other members of the region. Moreover, it was found that the proposed Sri Lanka-Bangladesh FTA will not much beneficial to both Sri Lanka and Bangladesh.

## 5.2.2 Trade Policy Options and its Impact on Different Industries in Sri Lanka

The table below depicts that projected results of the impact of different trade policy options on total export and import of industries in Sri Lanka.

**Table 5.1 Export and Import Directions of Sri Lankan Industries**

<b>Policy Option</b>	<b>Increase in Exports</b>	<b>Increase in Imports</b>
SAFTA	<ul style="list-style-type: none"> <li>• Oil seeds and vegetable oil</li> <li>• Metal Products</li> <li>• Paper products and publishing</li> <li>• Other primary products</li> <li>• Chemical rubber and plastic products</li> <li>• Beverage and tobacco</li> <li>• Capital intensive manufacturing</li> <li>• Milk products</li> <li>• Meat products</li> <li>• Other food products</li> </ul>	<ul style="list-style-type: none"> <li>• Sugar</li> <li>• Rice</li> <li>• Plant based fibers and crops</li> <li>• Fish products</li> <li>• Food products necessities</li> </ul>
South Asian Customs Union	<ul style="list-style-type: none"> <li>• Plant based fibers and crops</li> <li>• Meat products</li> <li>• Food products necessities</li> <li>• Other food products</li> <li>• Leather and wood products</li> <li>• Paper products and publishing</li> <li>• Metal products</li> <li>• Milk products</li> <li>• Other manufacturing</li> <li>• Other primary products</li> <li>• Services</li> <li>• Natural resources</li> </ul>	<ul style="list-style-type: none"> <li>• Sugar</li> <li>• Rice</li> <li>• Oil seeds and vegetable oil</li> <li>• Beverage and tobacco</li> </ul>

Indo Lanka FTA (full trade liberalization scenario)	<ul style="list-style-type: none"> <li>• Metal products</li> <li>• Paper products and publishing</li> <li>• Electronic equipment</li> <li>• Chemical, rubber and plastic products</li> <li>• Machinery and equipment necessities</li> <li>• Other primary products</li> </ul>	<ul style="list-style-type: none"> <li>• Rice</li> <li>• Wheat and cereal grain</li> <li>• Food products necessities</li> <li>• Vegetable, fruits and nuts</li> <li>• Fish products</li> </ul>
Indo Lanka FTA (with negative list)	<ul style="list-style-type: none"> <li>• Metal products</li> <li>• Paper products and publishing</li> <li>• Electronic equipment</li> <li>• Machinery and equipment necessities</li> <li>• Other primary products</li> </ul>	<ul style="list-style-type: none"> <li>• Machinery and Equipment necessities</li> <li>• Electronic equipment</li> </ul>
Sri Lanka Bangladesh FTA	<ul style="list-style-type: none"> <li>• Oil seeds and vegetable oil</li> <li>• Metal products</li> <li>• Capital intensive manufacturing</li> <li>• Other food products</li> </ul>	<ul style="list-style-type: none"> <li>• Natural Resources (oil , gas)</li> </ul>
Multilateral Trade Liberalization	<ul style="list-style-type: none"> <li>• Wearing apparel</li> <li>• Leather and wood products</li> <li>• Paper products and publishing</li> <li>• Electronic equipment</li> <li>• Other primary products</li> <li>• Metal products</li> <li>• Beverage and tobacco</li> <li>• Other primary products</li> <li>• Natural resources</li> </ul>	<ul style="list-style-type: none"> <li>• Wheat and cereal grain</li> <li>• Vegetable, fruits and nuts</li> <li>• Oil seeds and vegetable oil</li> <li>• Rice</li> <li>• Sugar</li> <li>• Milk products</li> <li>• Fish products</li> <li>• Meat products</li> <li>• Food products necessities</li> <li>• Chemical, rubber and plastic products</li> <li>• Other manufacturing</li> <li>• Petroleum and coal products</li> <li>• Capital intensive manufacturing</li> <li>• Services</li> </ul>

Source: Simulation results derived from GTAP version 6 (Database 2001)

From the estimated results it can be concluded that under all trade policy options the manufacturing sector will benefit more than the agricultural sector. It could be seen that in most of the manufacturing sectors exports will increase under the trade liberalization scenarios than imports. It could be revealed that the metal product industry will immensely benefit under all trade policy options and therefore, it can be concluded that

Sri Lanka's metal products have good opportunity in the world market. However, rice and sugar appeared to be importing products under all trade policy options.

### **5.3 Recommendations**

#### **5.3.1 Proposed Trade Policy Options for Sri Lanka**

It was apparent that for Sri Lanka regionalism should be served as the first best trade policy option under multilateral trading system. Also among different trade policy options under the regionalistic approach Sri Lanka might rather focus on implementing the SAFTA as the SAFTA ensures the highest welfare to Sri Lanka among the regional trade policy options considered under the study. It seems to be for Sri Lanka that the SAFTA as complementary and the regionalism can help to sustain multilateralism. In other words RTAs should be rather “building blocks” towards freer global trade than being stumbling blocks ( Bhagwati and Panagariya:1993). Therefore, it can be seen that the finding of the study is consistent with the theoretical framework of the economic integration.

Further, the most powerful economic arguments against regional and bilateral trade agreements are that they can cause trade diversion and trade distortions and ultimately undermine the multilateral system because of their discriminatory nature. However, from the estimated results it was revealed that the SAFTA can be formed without causing significant trade diversion effects, or without being seriously harming to the outside members of the RTA. Further, it was estimated that the present intra trade share in the South Asian region will change as follows under different trade policy options.

**Table 5.2**            **Projected Changes of Intra Regional Trade Share under  
Different Trade Policy Options**

<b>Policy Option</b>	<b>Projected Intra Trade Level (Percentage)</b>
SAFTA	6.2
South Asian Customs Union	5.8
Indo Lanka Full Trade Liberalization Scenario	4.5
Indo Lanka FTA (with negative list)	4.3
Sri Lanka Bangladesh FTA	4.2
Multilateral Trade Liberalization	4.6

Source: Estimated from the simulation results derived from GTAP version 6  
(Database 2001)

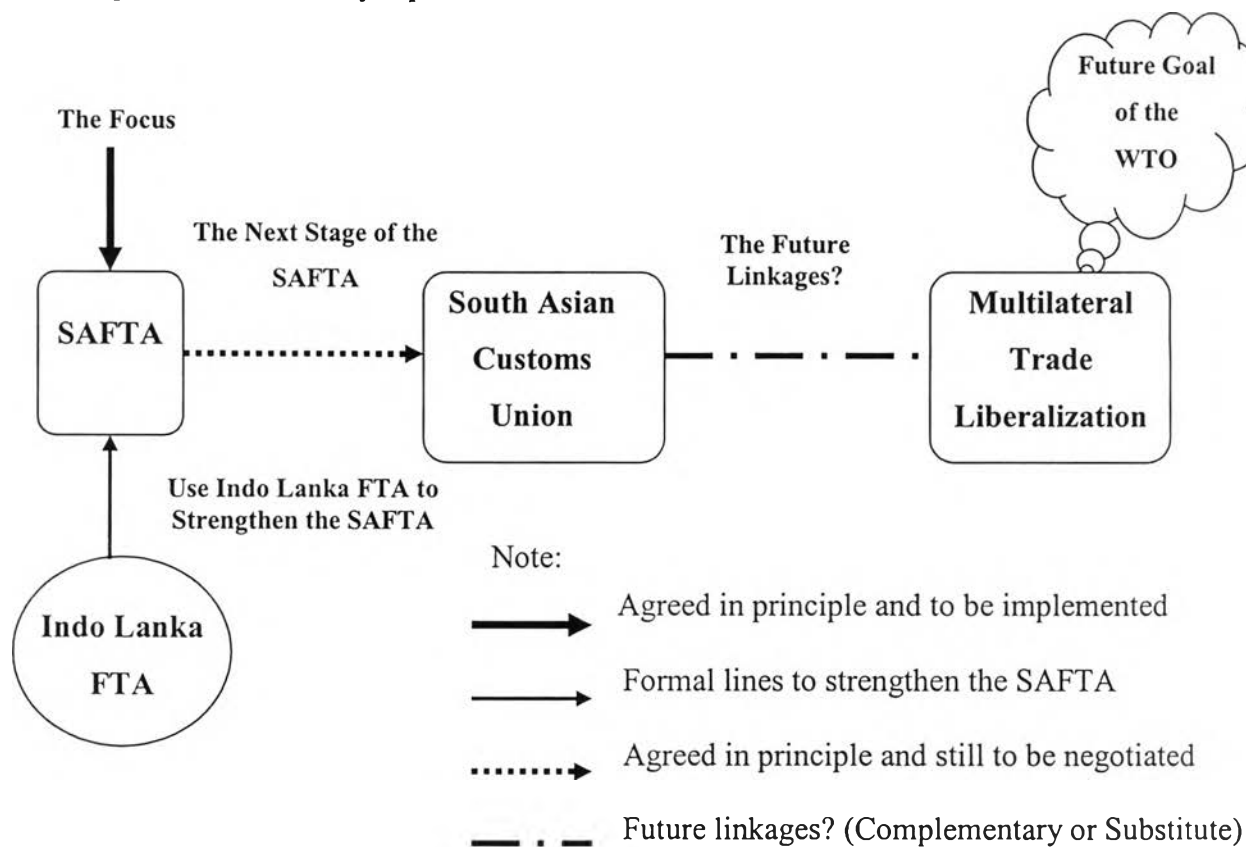
From the estimated results it can be concluded that under the SAFTA it appeared South Asian countries will trade more with the regional trading partners or in other words the trade creation effect is highest in the case of the SAFTA. It was found that under the SAFTA trade between India and Pakistan will also increase. This is a positive move to regional integration in South Asia, as India and Pakistan are the two largest economies in the region.

It is apparent that the present Indo Lanka FTA will also contribute to enhance intra trade share in the region. In addition, it could be seen that the proposed Sri Lanka-Bangladesh FTA does not make any contribution to boost up the present intra trade share in the region. Moreover, it was revealed that the South Asian countries tend to trade less with the regional trading partners when moving to the deeper integration stages.

For the Sri Lanka's point of view it is important to cooperate with the regional trading partners as Sri Lanka, being a small economy cannot compete in the world market by herself alone. Hence, Sri Lanka needs to join with the other regional trading partners and implement the SAFTA to expand its opportunities to world market. The diagram below demonstrates the proposed trade policy options for Sri Lanka.



## Proposed Trade Policy Options for Sri Lanka



As illustrated in the diagram it is recommended to Sri Lanka to focus on implementing the SAFTA. In addition, Indo Lanka FTA can also be continued to strengthen the SAFTA. The next stage of the SAFTA is transforming the SAFTA into South Asian Customs Union, which already included in the agreement. However, this trade policy option still to be negotiated. Finally, it could be seen that the SAFTA needs still to find it linkages (complementary or substitute) to the multilateral trade liberalization.

### **5.3.2 Strategies for the Different Industries in Sri Lanka under the SAFTA**

From the study, it was recommended that Sri Lanka need to focus on implementing the SAFTA as it helps to enhance the welfare of the country. In implementing the SAFTA it is important that government should make appropriate policies and link with the industrial sector in Sri Lanka, particularly the private sector in Sri Lanka plays a significant role in the economy. Hence, the government should build a proper network with the industrial sector, including private sector, research institutions and universities in Sri Lanka in successfully implementing the SAFTA. For instance, the government can make use of research undertaken by the universities to develop industrial sector in the country. Encouraging research and development is immensely important to bring innovative products and proper training is vital to human resource development in the country.

Form the study it was revealed that manufacturing sector in Sri Lanka will benefit more than the agricultural sector. It could be seen that Sri Lanka is a net importer of many of agricultural products under the SAFTA. Rice and sugar sectors appeared to be major imported products under the multilateral trade liberalization. The following are the recommendations for some important industries in Sri Lanka.

#### **i. Agricultural Sector**

Agriculture remains an important sector in Sri Lanka with one third of the population engaged in agricultural or related activities. It was found that under the SAFTA import of most agricultural products appeared to be increased. The poor performance of the agricultural sector may be attributed, inter alia, to low levels of investment, lack of quality inputs, heavy dependence on regular rainfall, traditional cultivation practices, lack of credit, inadequate infrastructure (notably transportation), weaknesses in the marketing system, state control of land, and inconsistent trade policies. Adoption appropriate trade policy could lead to a better allocation of resources, thus raising productivity and increasing living standards. In addition, the establishment of a transparent land tenure system might make farmers more willing to invest and to adopt modern farming technologies.

- **Rice**

The study found that the rice production in Sri Lanka is not sufficient to cater the demand of the domestic consumption. Hence, rice appeared to be one of the imported products in Sri Lanka. Therefore, policies should be made to improve productivity and reduce inefficiencies in the rice sector include promoting R&D and agricultural extension services, improving irrigation and market facilities, modernizing rice mills, and improving storage and transportation facilities. Moreover, promoting crop diversification and shifting from paddy to other productive and profitable cash crops (particularly among marginal farmers in the wet zone of Sri Lanka) are also important. Government and private sector should get together and help rice producers to better cope with trade policy reforms and to improve efficiency in the rice sector in Sri Lanka.

- **Vegetables and Fruits**

The study found that vegetable and fruits sectors in Sri Lanka are also not much gaining under the SAFTA. One of the significant draw back in the Sri Lankan vegetable and fruit farmers are lack of skills and knowledge on improving quality and enhance value addition of the products. Therefore, it is recommended that the agricultural research institutions should carryout research on enhancing the genetic stock of materials, introduce proper seeds to obtain better products, introduce new storage systems to preserve the vegetable and fruits. Further, it is important to give proper training to farmers on marketing and need to help them to find new markets for their products.

- **Sugar**

From the statistics, it was identified that import of sugar will increase under the SAFTA. This is because due to decline in sugarcane cultivation and sugar production in Sri Lanka. The government sold most of sugar factories to private sector to increase the efficiency in the sugar production. Therefore, it is recommended that the private sector should take actions to reduce inefficiencies in sugar production by introducing new improved cane variety using new technology.

- **Fish Products**

According to the results, it could be seen that fish products import will increase marginally, in Sri Lanka under the SAFTA. Therefore, it is recommended that government should cooperate with the private sector and enter into partnership with private sector for activities like harbor development, shore facilities and fishing related activities. Further, it is needed to improve the quality of the fish through fish landing, potable water, auctioning, marketing facilities, fish finding equipment etc. Moreover, it is important to facilitate and encourage fishermen by providing financial assistance and private sector subcontracting to provide and market quality and hygienic fish products.

- **Oil seeds, Vegetable oil and Other Food Products**

The study found Sri Lanka's export of oil seeds, vegetable oil and other food products which include processed foods will increase due to trade liberalization. Hence, it is recommended that government should encourage and provide assistance to small and medium scale enterprises to produce processed foods and vegetable oil in complying with international standards.

- **Milk Products and Meat Products**

Under SAFTA it could be identified that opportunities for export of milk products and meat products of Sri Lanka will increase. Therefore, it is recommended for the government to encourage private sector to invest in this sector to enhance the quality of the services to upgrade the livestock in the country. For instance, services like animal health and delivery of vaccination, laboratory services, testing for quality of the product should be handed over to the private sector.

## ii. **Manufacturing Sector**

According to the estimated results it could be revealed that the export opportunities will expand in manufacturing sector in Sri Lanka under the SAFTA. Therefore, industrial policy should be strengthen the existing export orientation of the country's manufacturing sector. The strategy will be to promote such industries in line with their own potential in terms of market size, liberalization commitments, and trade

agreements in order to ensure competitiveness. Industry promotion requires a system of policy based financing and support of reliable and efficient infrastructure facilities. The recommendations can be made to the following industries based on the finding of the study.

- **Textile and Garment Industry**

The results of the study indicated that there is no much impact on the garment industry in Sri Lanka under the SAFTA as a total. However, according to the figure 4.22 in chapter 4 it could be seen that Sri Lanka's bilateral exports of garments to India, Bangladesh and the Rest of South Asia will increase under the SAFTA. Further, according to the table A.21 in appendix it reflected that Sri Lanka's garment exports to USA, EU and the other regions will decline. This is because of phasing out the quota regime in year 2005, and losing its guaranteed markets under the quota regime, which is a biggest challenge for Sri Lanka. In this context, it could be seen that under the SAFTA, export opportunities will open in the South Asian region. Thereby Sri Lanka will be able to minimize the losing of its market in other regions.

The main drawback that industry faces is insufficient textile production in the local market to manufacture garments. Hence, it is recommended that Sri Lanka to corporate with other regional trading partners under the SAFTA, and create backward linkages to increase textile production in the country. This will help to reduce the lead time of completing an order. Further, it is recommended to the garment manufacturers to produce garments suits to low income groups in the South Asian region. This is good opportunity to the small and medium scale enterprises as they are adversely affected by phasing out of quota regime. Further, it can be recommended to the government to initiate steps to enhance skills and knowledge of the employees and provide appropriate training to the workers with the collaboration of the private sector. Further, it is important to establish fashion institutes to develop new designs to manufacture more fashion garments and value added products to retain the present market in the USA and EU.



- **Metal products**

From the study it was found that metal products of Sri Lanka has highest export potential in the international market under the SAFTA. The study estimated that bilateral exports of metal products to India expected to increase by 157.5 percent, to Bangladesh by 122.6 percent and to Rest of South Asia by 90 percent under the SAFTA. Therefore, it is recommended that the government should pay more emphasis on metal product sector in Sri Lanka by encouraging industrialists and help them to market their products in international market. The role of the private sector is also very important in this regard in undertaking scientific research to introduce new metal products and upgrade the existing metal products.

- **Tea Industry**

Tea industry appears to be marginally gaining under the SAFTA. This is important for Sri Lanka as Sri Lanka is pioneering tea exporter to the world market and already gain reputation in the global market. Therefore, it can be recommended to develop fully Sri Lankan owned fine quality pure “Ceylon Tea” brand names including joint ventures between plantation companies and tea traders. Further, it could be recommended to introduce more value added tea products such as ready to drink tea to the world market. In addition, it is important that Sri Lanka’s Tea Board (Tea Promotion Bureau), Export Development Board and other organizations to share responsibility for marketing and promoting tea to the world market.

- **Chemical Rubber and Plastic products**

The results indicate that export of chemical, rubber and plastic products will increase under trade liberalization programme. For instance, Sri Lanka’s bilateral export to India is estimated to increase by 111.1 percent, to Bangladesh by 57.8 percent and to Rest of South Asia by 36.5 percent. This is important to rubber and plastic products manufacturers in Sri Lanka, as rubber is one of the main industry in Sri Lanka. For instance Sri Lanka can increase production of tyres as there is a demand for tyres in India from Bajaj three wheeler manufacturing company and Tata vehicle manufacturing industry. The rubber research institute should undertake research and development

activities to enhance the value addition of the rubber products to fully capturing the opportunities in the international markets.

- **Paper products and publishing**

From the study it was revealed that export of paper products and publishing will increase due to trade liberalization programme. Therefore, it is recommended to introduce new printing techniques and advanced machinery with modern technology to produce quality output, which is can be attracted by the international market.

## **5.4 Limitations of the Study and Recommendations for Future Study**

### **5.4.1 Limitations of the Study**

This research had been undertaken with the prime objective of determine the impact of South Asian free trade area and policy options for Sri Lankan economy. The study conducted six policy scenarios and GTAP version 6 (2001) database had been used to determine the welfare impacts of each policy outcome. In performing simulations, the study used the standard GTAP model in the long run framework. However, the standard GTAP model could capture only static welfare impacts and it could not capture dynamic impacts that arise in the long run as a result of trade liberalization.

Further, the results of the study were presented based on the GTAP database industry classification. However, it could not aggregate them in a sensible way according to the HS code classification. Moreover, the standard GTAP model could not capture the impact on government revenue as a result of tariff reduction under trade policy scenarios.

Further, according to the literature review it could be seen that informal trade in the SAARC region is one of a major issue for having low intra trade in the region. However, the study was based only on the formal trade among the region, as informal trade statistics were not recorded in the GTAP data base.

### 5.4.3 Recommendations for Further Study

#### a) Recommendations for Further Study due to Limitations in the Scope and the Methodology

As trade liberalization programmes bring dynamic benefits in the long run as a result of increase competition and improvement in productivity it is important to undertake further research by focusing on dynamic effects of trade liberalization.

Tariff reductions due to trade liberalization will be affected to the government revenue and this is an issue for countries that depend on import tariff revenue. Therefore, it is important to undertake a study on impact on government revenue due to reduction of tariffs as a result of trade liberalization.

Moreover, it is vital to undertake further research on commodities that Sri Lanka trade in the international market according to HS code classification. Descriptive method will be more appropriate to undertake these kinds of studies. Further, it is important to carryout studies on informal trade in the SAARC region, as this issue appeared to be one of main issue in the South Asian region to boost up the intra trade share in the region.

#### b) Recommendations for Further Study to successfully implementing the SAFTA

As the present study found that the SAFTA helps to enhance the welfare in the Sri Lanka and other South Asian countries, it is important that regional trading partners should corporate and initiate steps to implement the SAFTA. In this context, it is important to further study on the factors that could help to enhance the share of intra trade and FDI in the region. Studies on following aspects are important in this regard.

- Building complementary trade structure in the region
- Product and market diversification
- Enhance value addition of traditional commodities in the region through upgrade technology and innovation
- Trade facilitation and economic integration
- Establishment of common investment area in the South Asian region



## 5.5 Summary

This chapter presented the conclusion and recommendations on different trade policy options for the Sri Lankan economy. The study concluded that the multilateral trade liberalization is the best policy outcome for Sri Lanka and to the other South Asian regional trading partners. Moreover, it was concluded that the SAFTA ensures highest welfare to Sri Lanka and to the other South Asian countries among the RTAs and the other bilateral trade agreements. In addition, it could be estimated that the share of intra trade in the South Asian region will increase up to 6.2 percent under the SAFTA, under the South Asian Customs Union up to 5.8 percent and under multilateral trade liberalization up to 4.6 percent from the current intra trade share of 4.2 percent in the base year 2001. From this was could determine that the South Asian countries tend to trade less with their regional trading partners when they move to higher levels of economic integration.

Moreover, based on the industry analysis it could be concluded that the manufacturing sector will benefit more than the agricultural sector under different trade policy options considered in the study.

Even multilateral trade liberalization ensures highest welfare to Sri Lanka, since it takes long time to reach this policy outcome it could be recommended that Sri Lanka should focus on implementing the SAFTA since regionalism and multilateralism are complementary and regionalism can help to sustain multilateralism. Further, it could be recommended that the Indo Lanka FTA can also be continued to strengthen the SAFTA, as it does not bring significant harmful effects to the other regional trading partners.

In addition, recommendations had been made to the Sri Lankan industrial sector to make effective strategies to enhance the benefit of implementing the SAFTA. Finally, limitations of the study and recommendations for further study had been presented to make use of the results of the present study for future academic research in the area of South Asian economic integration.