

BIMSTEC-Japan Cooperation in Trade and Investment: A Sri Lankan Perspective

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BIMSTEC-Japan Cooperation in Trade and Investment: A Sri Lankan Perspective

Janaka Wijayasiri and Deshal De Mel*

Abstract: BIMSTEC is one of many regional trade agreements that Sri Lanka has signed up to. At present the potential for benefits from the BIMSTEC agreement are limited to increased access to markets of Thailand's and Myanmar since Sri Lanka already has access to India, Bangladesh, Bhutan, and Nepal through ILFTA and SAFTA, respectively. In this context, the addition of a new country, Japan to BIMSTEC would increase the potential benefits to Sri Lanka. Furthermore, Sri Lanka continues to seek increased diversification of export markets which are at present concentrated in Europe and the USA.

However, a lot of work needs to be done to get BIMSTEC's own house in order before countries like Japan would even be interested in getting involved in such an agreement. Low trade coverage, high transactions costs to trade and existing FTAs are cases in point. Japan could however play an important role in boosting economic cooperation in BIMSTEC if it were to join. For instance, building transport infrastructure will be crucial to promote regional cooperation and in this regard Japanese ODA can play a significant role. Furthermore, the entry of Japan would boost competition in the region and act as a catalyst for upgrading quality and standards of production and service supply in the region. These potential dynamic benefits will make it worthwhile giving strong consideration to Japan's entry into BIMSTEC whilst being aware of the challenges that have been outlined in this paper.

1. Introduction

Regional trade arrangements (RTAs) have become a significant feature of the world trading system in recent times. Almost all countries in the world are now members of at least one or more RTAs while some are party to 20 or more. According to the WTO, the number of such

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arrangements has surged since the early 1990s and there are some 386 RTAs notified as of end December 2006 with still more in the pipeline. By 2010, it is estimated that close to 400 RTAs will be in existence. The growth in the number of RTAs and their increasing importance is reflected by the steady rise in share of preferential trade – trade between members of RTAs account for about one-third of total global trade at present. While RTAs have sprung up across the world, Asia-Pacific and Latin American regions have witnessed the largest proliferation of arrangements in recent times. The sluggish progress under the current Doha Round launched in 2001, which was expected to have been concluded in 2005, is likely to fuel the surge in RTAs already witnessed, as countries scramble to partner up with more countries. In fact, a number of countries announced their intention of signing up RTAs with their major trading partners following the suspension of the Doha Round in July 2006. In this context, regional cooperation arrangement amongst the five countries in South and South East Asia (Bangladesh, Bhutan, India, Myanmar, Nepal, Sri Lanka and Thailand) or BIMSTEC (Bay of Bengal Initiative of Multi-Sectoral and Technical Cooperation) is one of the more recent RTAs in the Asian region, which aims to develop into a free trade arrangement by concentrating on activities facilitating trade, increase investments and promote technical cooperation.

The BIMSTEC region has a combined GDP of US\$ 940 bn and contains 1.3 bn people accounting for one-fifth of the world's population. The membership is a mixed bag of countries, each one at different stages of development - 3 of the members are non-LDCs (India, Sri Lanka and Thailand) and 4 are LDCs (Bangladesh, Bhutan, Myanmar and Nepal). India is the largest economy in the region and alone accounts for more than 80 percent of the population and more than 70 percent of the GDP of the BIMSTEC. The complementarities among the countries were considered to be substantial given the different levels of economic development and resource endowments of the economies thus providing a basis for regional cooperation. In addition, all the countries in the grouping share a common border with one another providing an important condition for regional economic cooperation. However, intra-regional trade has been low

and the full potential of intra-regional trade was considered untapped due to tariff and non-tariff barriers, poor communication and transport links, lack of information, among others (RIS, 2004). Intra-regional investments too have been small despite the potential for market and efficiency seeking investments in the region. It was thought that regional cooperation in this context could help exploit these dormant potentials existing in the sub-grouping.

Japan is the second largest economy in the world after the US and accounts for a substantial share of global trade in goods and services, ranking amongst the top 5 exporters and importers of goods and services in the world. Japan is also a significant investor in the world, including Asia, and it is also amongst the largest donors in the world – both bilaterally and multilaterally. Japan maintains very good relationship with BIMSTEC countries and is already an important partner of countries in the BIMSTEC region in main respects – as a trading partner, investors, as well as a donor. In this light, studies done by CSIRD indicates that Japan can be considered a valuable partner for the BIMSTEC given its potential to contribute to the promotion of economic cooperation in the region. Japan too has the potential to gain from partnering with the BIMSTEC by assisting in the economic expansion of the country through diversifying of its economic partners and securing its access to enlarged market in the South and South East region of Asia. While Japan has historically been less inclined to sign RTAs, with the slow progress seen under the Doha round, it is increasingly seeking market access abroad by negotiating trade arrangements or Economic Partnership Agreements (EPAs) with a number of countries in the region and beyond.¹ Japan's new found urgency for EPAs has been prompted in part by neighboring countries like South Korea and China negotiating with Japan's major trading partners. While the BIMSTEC as a region has not been approached to form an EPA with Japan, the two largest partners in the region, India and Thailand have struck or in the process of negotiating a deal with Japan.

This paper would look at the opportunities and challenges to BIMSTEC-Japan cooperation in trade and investment from the

perspective of Sri Lanka, which is one of the founding members of the region grouping. The remainder of the paper is organized as follows. First, the paper would provide a brief overview of the BIMSTEC and the negotiations on trade and investment undertaken by the region to date and the current status of trade within the region. Second, the paper would briefly outline the importance of the region to Sri Lanka (in terms of trade, services and investment) before highlighting the importance of Japan for the BIMSTEC region more specifically to Sri Lanka as a trading partner and investor. Fourth, it would present the potential benefits and challenges of widening the BIMSTEC to include Japan.

2. Background of BIMSTEC

Realizing the importance of economic cooperation between South and South East Asia, Thailand took the initiative in 1994 to explore the possibility of formation of a sub-regional group. With the backing of the Asian Development Bank (ADB) and UN-ESCAP, the four-nation RTA – Bangladesh-India-Sri Lanka-Thailand Economic Cooperation (BIST-EC) was created on 6 June 1997 in Bangkok, Thailand, thereby bridging India’s Look East policy with Thailand’s “Look West” Policy. Initially Myanmar was only an observer, but was soon granted full membership at a special ministerial meeting held in Bangkok on 22 December 1997. Consequently, the name of the organization was changed to BIMSTEC to reflect the members of the grouping. Nepal was granted observer status by the second Ministerial Meeting in Dhaka, Bangladesh in December 1998. Nepal and Bhutan soon joined as full members in 2003. During the first BIMSTEC Summit in Bangkok on 31 July 2004, the organization was renamed as Bay of Bengal Initiative for Multi-sectoral Technical and Economic Cooperation (BIMSTEC).

This sub-regional group not only aims at increasing intra-regional trade among the members but also covers other areas of cooperation. Initially, only 6 priority sectors were decided upon, namely Trade and Investment, Technology, Energy, Transport and Communication, Tourism, and Fisheries. The list was expanded after the first BIMSTEC Summit in 2004 to encompass 13 sectors: Agriculture, Cultural Co-

operation, Environment and Disaster Management, Public Health, People-to-People Contact, Poverty Alleviation and Counter-Terrorism and Transnational Crimes.

2.1 Negotiations in Trade and Investments to date

The first meeting of Commerce and Economic Ministers of the Grouping, held in August 1998 mooted the idea that BIMSTEC should aim to develop into a free trade arrangement and that it should focus on activities that facilitate trade, investment, and promote economic cooperation. Subsequently BIMSTEC decided to establish an FTA and a framework agreement for BIMSTEC Free Trade Area (FTA) was signed by all countries except Bangladesh in February 2004 (Bangladesh later acceded to the Agreement on 25 June 2004 through a protocol). The Agreement envisions liberalization, promotion and facilitation of trade in goods and services, investments, as well as broader economic cooperation². Thus, BIMSTEC goes beyond trade in goods unlike other trade arrangements in the region such as SAPTA/SAFTA, APTA to name a few

Trade Negotiating Committee (TNC) was set up with the task of negotiating the programme³. Negotiations on trade in goods were to be completed by the end of 2005 for implementation in July 2006 after which the TNC would proceed to negotiate on trade in services and investment (to have been concluded by 2007). So far, there have been 15 TNC meetings but countries have failed so far to iron out contentious issues like rules of origin, and negative lists, which form the building blocks of an FTA. The focus of negotiations has been on the trade in goods while discussions on services and investments are still at the very initial stages. Having missed the deadline of end 2005 for completion of trade negotiations and the July 2006 deadline for the implementation of the agreement, TNC was mandated to finalize the agreement before the Second Summit meeting in February in India 2007, which was subsequently called off. The 16th TNC meeting was held in September 2007 in Dhaka, Bangladesh.

The BIMSTEC member countries have agreed to take a Negative List approach to tariff liberalization, which means a certain percentage of products that are considered sensitive would not be subjected to

tariff cuts. The Negative List of a country is expected to be set at 20 percent of total tariff lines at 6- digit level, which means roughly about 1050 item of Sri Lanka's tariff lines would not be subjected to liberalization – this is slightly smaller than the number of items under SAFTA (1065) or ILFTA (1200 odd items). At the last TNC meeting, member countries exchanged their revised Negative List. Despite the agreement to limit the Negative List to 20 percent of the total tariff lines, Thailand has expressed its desire to bring down the Negative List further to 10 percent and also suggested the application of the concept of reciprocity in determination of the Negative List of products. Other member countries including Sri Lanka have not viewed this favourably.

With regard to Rules of Origin, member countries are yet to agree on a figure for domestic value addition under the General Rule. Thailand favours a 30 percent value addition in addition to the Change of Tariff Heading (CTH) at 4 digit level for all the member countries while rest of the countries including Sri Lanka have suggested to extend 30 percent value addition for LDCs and 35 percent for non-LDCs (NLDCs) in conjunction with CTH to take into account different stages of development of member countries. Member countries have also expressed the need to provide derogations from the general Rules of Origin by applying specific rules of origin for some 1200 products (Sri Lanka has suggested some 295 products for consideration). Specific rules of origin vary from product to product and are less stringent than the general rules of origin in terms of value addition and CTH (i.e.) at 6 digit level rather than at 4 digit level.

Liberalisation of goods would be done in two approaches: 'fast track' (FT) liberalization between 2007 and 2011 and 'normal track' liberalization (NT) between 2007 and 2017 depending upon the level of development of member countries. Under the fast track approach, tariffs on identified products would be brought reduced or eliminated by India, Thailand and Sri Lanka (the non-LDCs) for LDCs within one year (2007) from the date of implementation and LDCs would do the same for NLDCs in five years (2011). Thus, Sri Lanka would have access to products listed under the Fast Track in other NLDCs by 2009 and LDCs by 2011. In turn, Sri Lanka would provide access

Table 1: Tariff Reduction Schedules under Fast Track (FT) and Normal Track (NT)

	Countries	For NLDCs	For LDCs
Fast Track	IN, SL, TH	1 July 2006 - 30 June 2009	1 July 2006 - 30 June 2007
	BG, BH, MY, NP	1 July 2006 - 30 June 2011	1 July 2006 - 30 June 2009
Normal Track	IN, SL, TH	1 July 2007 - 30 June 2012	1 July 2007 - 30 June 2010
	BG, BH, MY, NP	1 July 2007 - 30 June 2017	1 July 2007 - 30 June 2015

Source: Framework Agreement on the BIMST-EC FTA, BIMSTEC Chamber of Commerce, Sri Lanka (www.bimstec.org)

to its products under Fast Track to other NLDCs by 2009 and LDCs by 2007. The number of products to be liberalized under the fast track would be limited to 10 percent of total tariff lines at 6-digit level, which would amount to about 514 products in the case of Sri Lanka.

Under the normal track approach, there would be a reduction and elimination of tariffs over a period of 11 years from the date of implementation. Products identified for tariff elimination would be made duty free and those identified for tariff reduction would be brought down to 0-5 percent range by NLDCs for LDCs in four years (2010) while LDCs would do so for NLDCs in eleven years (2017). In the case of Sri Lanka, it would have access to products listed under Normal Track in NLDCs by 2012 and LDCs by 2017. In turn, Sri Lanka would provide access to its products under Normal Track for NLDCs by 2012 and 2010 for LDCs. The list of products to be liberalized under the normal track would account for 70 percent of total tariff lines at 6 digit level. In the case of Sri Lanka, of the 70 percent tariff lines, 55 percent of which would be eliminated and another 15 percent would be reduced to 0-5 percent range.

2.2 Intra-BIMSTEC Trade

Tables 2-4 show intra-regional exports, imports and total trade amongst the BIMSTEC countries. Intra-regional trade within BIMSTEC has increased over time (from around 2.5 percent in the 1990s) but still remains very low at 4.64 percent like in the case of SAARC. But for countries in the region other than India and Thailand, the region is an important destination of exports and source of imports. Intra-regional trade was most significant for Nepal (accounting for 50 percent of its total trade), followed by Myanmar (41 percent), Sri Lanka (17 percent) and Bangladesh (11 percent). Intra-BIMSTEC trade was least important for Thailand (2.6 percent), and India (3.6 percent).

Nepal's strong trade links in BIMSTEC is in reality due to its high dependency on trade with its neighbour, India – accounting for 54 percent of its total exports and 48 percent of its imports. In fact, India is the largest market for Nepalese exports and source of imports to Nepal. Similarly, BIMSTEC region accounted for 57 percent of

Table 2: Intra-regional Exports as % of Country's Total Exports, 2005

Exports to>>	BG	BH	IN	JP	MY	NP	SL	TH	BIMSTEC
Bangladesh		0.04	1.40	0.76	0.02	0.04	0.10	0.17	1.77
Bhutan									
India	1.67	0.10		2.43	0.11	0.85	1.91	1.04	5.68
Japan	0.09	0.00	0.59		0.02	0.00	0.06	3.79	4.55
Myanmar	0.79		12.15	5.00		0.00	0.10	43.91	56.96
Nepal	0.42		53.74	1.46	0.00		0.02	0.18	54.36
Sri Lanka	0.25		8.87	2.27	0.04	0.01		0.43	9.59
Thailand	0.36		1.38	13.66	0.64	0.02	0.18		2.58
BIMSTEC	0.91	0.04	1.32	7.84	0.36	0.38	0.91	1.18	5.11

Note: Blanks indicate lack of data. There was no data available on Bhutan.

Source: IMF DOTS 2006

Table 3: Intra-regional Imports as % of Country's Total Imports, 2005

Imports from>>	BG	BH	IN	JP	MY	NP	SL	TH	BIMSTEC
Bangladesh		0.08	14.09	4.12	0.23	0.02	0.07	2.28	16.77
Bhutan									
India	0.08	0.06		2.58	0.37	0.28	0.39	0.83	2.00
Japan	0.03	0.00	0.62		0.04	0.00	0.03	3.02	3.75
Myanmar	0.05		3.41	2.83		0.00	0.08	21.79	25.32
Nepal	0.20		47.58	1.10	0.00		0.02	1.44	49.25
Sri Lanka	0.10		20.71	4.28	0.05	0.00		1.90	22.75
Thailand	0.02		1.08	22.05	1.51	0.00	0.01		2.63
BIMSTEC	0.05	0.03	2.17	10.89	0.82	0.13	0.20	0.86	4.26

Source: IMF DOTS 2006

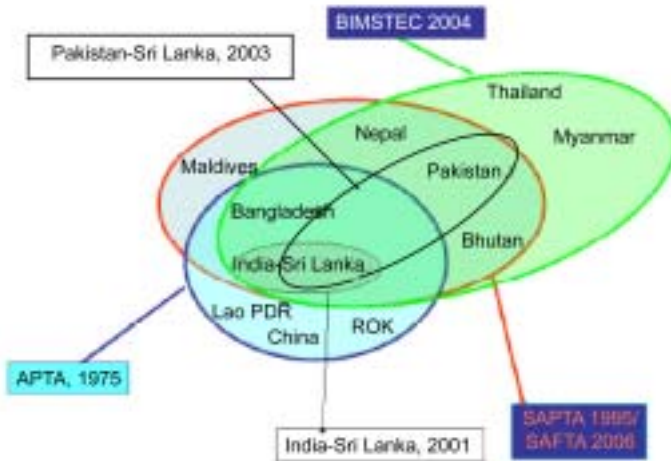
Table 4: Intra-regional (Trade as % of Country's Total Trade), 2005

TradeWith>>	Bangladesh	Bhutan	India	Japan	Myanmar	Nepal	Sri Lanka	Thailand	BIMSTEC
Bangladesh		0.06	9.26	2.84	0.15	0.03	0.08	1.48	11.07
Bhutan									
India	0.75	0.08		2.51	0.26	0.52	1.03	0.92	3.55
Japan	0.06	0.00	0.61		0.03	0.00	0.05	3.44	4.18
Myanmar	0.43		7.86	3.93		0.00	0.09	33.04	41.42
Nepal	0.26		49.10	1.19	0.00		0.02	1.13	50.51
Sri Lanka	0.16		15.75	3.44	0.04	0.00		1.28	17.24
Thailand	0.18		1.23	18.00	1.09	0.01	0.09		2.60
BIMSTEC	0.44	0.04	1.79	9.53	0.62	0.24	0.52	1.00	4.64

Source: IMF DOTS 2006

Myanmar's total exports and 25 percent of its imports. In the case of Myanmar, Thailand was of overwhelming importance (responsible for 44 percent of the country's exports and 22 percent of imports) followed by India. For Sri Lanka, 9 percent of its total exports go to

Chart 1: Spaghetti Bowl of RTAs involving Sri Lanka



Source: http://www.unescap.org/tid/projects/postdoha_s2mia.pdf

India and 21 percent of its imports come from India, which is the most important trading partner within BIMSTEC. India happens to be Sri Lanka's third largest export market and the single largest source of imports from the world. While the region is not an important export market for Bangladesh, it is an important source of imports for the country due to India, from which Bangladesh imported 14 percent of its import requirements. None of the BIMSTEC countries were particularly important export destinations or sources of imports for either Thailand or India.

Currently countries in the region are members of a number of other regional agreements such as SAPTA/SAFTA, ILFTA, BA/APTA to name a few, which provide access to each others markets under preferential terms. In the case of Sri Lanka, it already has market access to India, its largest trading partner in the region through the Indo-Lanka Free Trade Agreement and South Asian Preferential Trade

Table 5: Salient features of RTAs Signed by Sri Lanka

Agreement	Countries	# of items in the SL negative list	% of negative list items in SL list	Schedule	Rules of Origin	Services/ Investment
APTA	Bangladesh, China, India, Laos, Korea, Sri Lanka	Positive list.SL has given for 427 items.concession		Signed: 1975 Commenced: 1976	Domestic VA: 45% Cumulative VA: 60% For LDCs favourable 10 percentage points	Not covered
BIMSTEC	Bangladesh, Bhutan, India, Myanmar, Nepal, Sri Lanka, Thailand	1050	20%	Signed: February 2004 Commenced:Pending	Domestic VA: 35% with HS 4 CTH For LDCs domestic VA 30% withHS 4 CTH	To be covered
ILFTA	India, Sri Lanka	1220	23%	Signed: December 1998. Commenced: March 2000 SL will complete implementation in 2008.India completed implementation in 2003.	Domestic VA: 35% CTH: HS 4 digit	Covered under CEPA
PSFTA	Pakistan, Sri Lanka	697	13.3%	Signed: August 2002. Commenced: June 2005 SL will complete implementation in 2010 Pakistan will complete implementation in 2008.	Domestic VA 35% CTH: HS 6 digit	Not covered but considering
SAFTA	Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, Sri Lanka,	1065	20.4%	Commenced: January 2006. Non LDCs will complete implementation in 2012.SL will complete implementation in 2013 LDCs will complete implementation in 2015.	Domestic VA: 40% Cumulative VA: 50% provided that 20% domestic VA.For Sri Lanka: favourable 5 percentage points For LDCs: favourable 10 percentage point CTH:HS 4 digit	Not covered but considering

Sources: Department of Commerce, Govt. of India; SAARC Secretariat; UNESCAP; Department of Commerce, Sri Lanka.

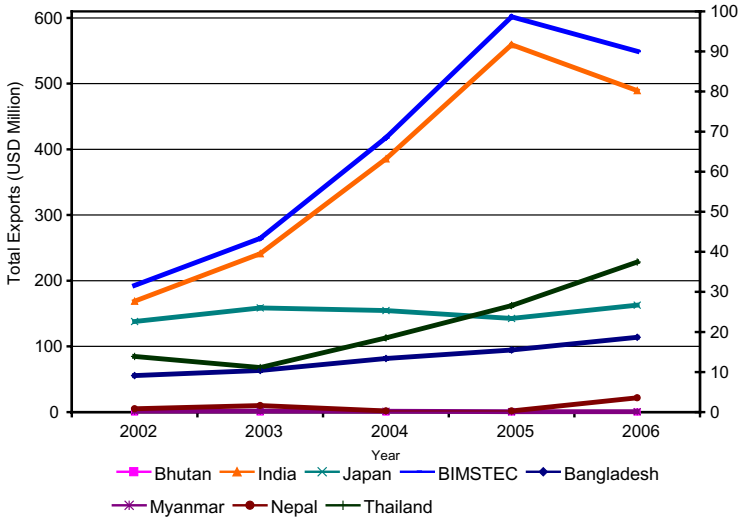
Arrangement, which was replaced by South Asian Free Trade Agreement and Bangkok Agreement, which was subsequently renamed as Asian Preferential Trade Arrangement (Chart 1). Similarly, Sri Lanka has access to Bangladesh under SAPTA/SAFTA and APTA while Sri Lanka has access to both Bhutan and Nepal under SAPTA/SAFTA. Sri Lanka does not have preferential market access either to Thailand or Myanmar other than through proposed FTA with BIMSTEC which is under negotiations⁴. In this context, Sri Lanka's interest in the BIMSTEC lies squarely with accessing markets in Thailand and Myanmar. Table 5 outlines the salient features of these trade agreements.

3. Importance of BIMSTEC to Sri Lanka

3.1 Trade

Overall exports of Sri Lanka to BIMSTEC countries have been increasing over the past 5 years (Chart 2), growing at a rate of 33 percent, since 2002 and reached a value of US\$ 549 million in 2006. This amounted to 8 percent of Sri Lanka's total exports. The growth in exports to the BIMSTEC region has come mainly from the increase in exports to India as a result of the Indo-Lanka FTA, which came into effect in 2001. Of the BIMSTEC countries, India is Sri Lanka's most important trading partner accounting for 89 percent of exports to the region. India is Sri Lanka's third largest export market (7 percent of Sri Lanka's total exports in 2006) after the US and UK with a share of 31 and 13 percent, respectively. Sri Lanka's exports to India have risen sharply since 2003 as a result of implementation of the third and final phase of the Indo-Lanka FTA (ILFTA) – which enabled Sri Lanka to export goods to India on duty-free terms except items on India's Negative List. As it can be seen from Chart 2, Sri Lanka's exports to BIMSTEC countries closely mirror its exports to India because none of the other BIMSTEC countries are significant export markets. After India, the second most important export destination amongst BIMSTEC countries is Thailand, buying 7 percent of Sri Lanka's exports, while Bangladesh has a share of 3 percent. Exports to Bhutan, Nepal and Myanmar have been negligible and stagnant over the observed period and these three countries together account for less than 1 percent of Sri Lanka's total exports.⁵

Chart 2: Exports from Sri Lanka to BIMSTEC & Japan (2002-06)



Note: Bhutan, Bangladesh, Myanmar, Nepal right axis

In terms of composition of exports to the BIMSTEC region (Table 6), Sri Lanka's exports to individual countries were concentrated in one or two sectors with base metals and fats and oils accounting for about 40 percent of exports to the region, largely due to India. But there was variation of exports products from Sri Lanka to countries in the region: Bangladesh (chemical products, textiles and textile articles), Myanmar (plastic and rubber, vegetable products), Nepal (pulp of wood), Thailand (precious stones).

In terms of importance of BIMSTEC as a destination for exports of Sri Lankan products, none of the countries other than India were of much importance. India accounted for a substantial share of exports from Sri Lanka in the following sectors: fats and oils, base metals, articles of stones, cement, chemicals, wood and articles, machinery and electrical equipment (Table 7).

Sri Lanka's imports from BIMSTEC tell a similar story to its exports to the region with India's dominating imports of the country from the region. The average growth in imports from the region has

Table 6: Sri Lanka's Exports (section-wise) to BIMSTEC, 2006

Description	BG	IN	MY	NP	TH	ALL
I Live animals and products	3.24	0.14	0.00	0.00	1.68	0.35
II Vegetable products	4.24	7.20	37.45	1.80	0.60	6.62
III Fats and oils	4.82	22.11	0.00	0.00	0.00	19.87
IV Prepared foodstuffs, beverages, etc.	0.84	1.78	7.98	2.29	0.19	1.64
V Mineral products	0.41	0.47	0.00	0.00	0.11	0.44
VI Chemical products	30.46	4.91	8.92	0.33	1.76	5.53
VII Plastics and rubber	10.47	4.78	44.22	0.17	2.28	4.78
VIII Hides and skins, leather, etc.	0.00	0.46	0.00	0.00	0.00	0.41
IX Wood and articles of wood	0.03	2.06	0.00	0.56	0.00	1.84
X Pulp of wood, paper, books, etc.	1.02	3.68	0.15	90.35	0.52	3.94
XI Textiles and textile articles	34.91	3.94	0.00	2.20	5.05	5.05
XII Footwear, headgear, umbrellas, etc.	0.00	0.02	0.00	0.00	0.10	0.03
XIII Articles of stone, cement, etc.	0.52	5.50	0.00	0.02	0.19	4.93
XIV Precious stones, etc.	0.00	0.41	0.00	0.00	84.42	6.12
XV Base metals and products	2.87	29.57	1.12	2.24	0.56	26.50
XVI Machinery and electrical equipment	2.15	10.46	0.16	0.00	1.10	9.47
XVII Transport equipment	0.46	0.78	0.00	0.00	0.00	0.71
XVIII Optical and precision instruments	0.00	0.10	0.00	0.00	1.36	0.18
XIX Arms and ammunition	0.00	0.00	0.00	0.00	0.00	0.00
XX Miscellaneous manufact. Articles	3.57	1.62	0.00	0.03	0.07	1.57
XXI Works of art, etc.	0.00	0.00	0.00	0.00	0.00	0.00
XXII Petroleum Products	0.00	0.00	0.00	0.00	0.00	0.00
Total	100.00	100.00	100.00	100.00	100.00	100.00
Value (US\$ mn)	18.68	489.49	0.11	3.57	37.46	549.32

Source: Compiled from Sri Lanka Customs Database

Table 7: Sri Lanka's Exports to BIMSTEC (% of HS Sector), 2006

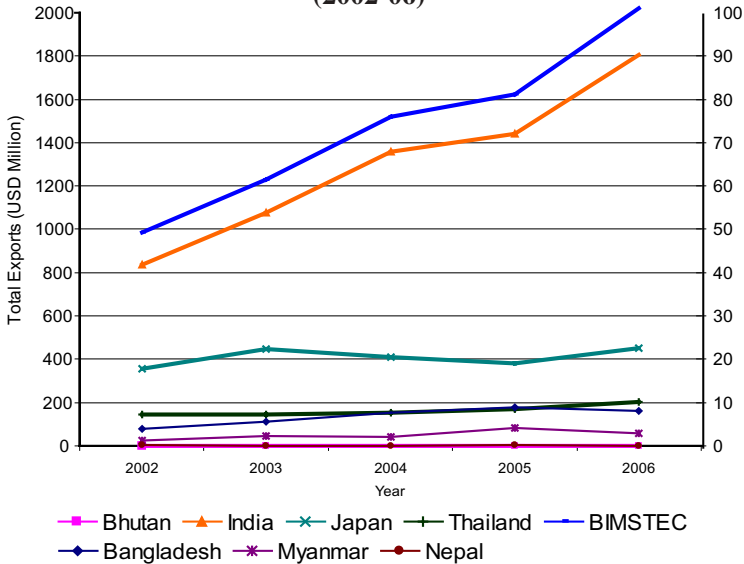
Description	Bangladesh	Bhutan	India	Myanmar	Nepal	Thailand	ALL
I Live animals and products	0.42	0.00	0.47	0.00	0.00	0.44	1.34
II Vegetable products	0.07	0.00	3.09	0.00	0.01	0.02	3.19
III Fats and oils	0.81	0.00	97.79	0.00	0.00	0.00	98.61
IV Prepared foodstuffs, beverages, etc.	0.11	0.00	6.16	0.01	0.06	0.05	6.39
V Mineral products	0.29	0.00	8.84	0.00	0.00	0.16	9.30
VI Chemical products	8.09	0.00	34.17	0.01	0.02	0.94	43.23
VII Plastics and rubber	0.33	0.00	3.89	0.01	0.00	0.14	4.37
VIII Hides and skins, leather, etc.	0.00	0.00	11.04	0.00	0.00	0.00	11.04
IX Wood and articles of wood	0.02	0.00	32.42	0.00	0.06	0.00	32.50
X Pulp of wood, paper, books, etc.	0.44	0.00	41.14	0.00	7.35	0.44	49.38
XI Textiles and textile articles	0.21	0.00	0.62	0.00	0.00	0.06	0.89
XII Footwear, headgear, umbrellas, etc.	0.00	0.00	0.24	0.00	0.00	0.09	0.34
XIII Articles of stone, cement, etc.	0.13	0.00	36.75	0.00	0.00	0.10	36.98
XIV Precious stones, etc.	0.00	0.00	0.49	0.00	0.00	7.72	8.21
XV Base metals and products	0.32	0.00	86.78	0.00	0.05	0.13	87.28
XVI Machinery and electrical equipment	0.18	0.00	23.36	0.00	0.00	0.19	23.73
XVII Transport equipment	0.06	0.00	2.76	0.00	0.00	0.00	2.82
XVIII Optical and precision instruments	0.00	0.00	1.98	0.00	0.00	2.02	4.01
XIX Arms and ammunition	0.00	0.00	0.00	0.00	0.00	0.00	0.00
XX Miscellaneous manufact. Articles	0.80	0.00	9.57	0.00	0.00	0.03	10.40
XXI Works of art, etc.	0.00	0.00	14.53	0.00	0.00	0.00	14.53
XXII Petroleum Products	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Total	0.28	0.00	7.23	0.00	0.05	0.55	8.12

Source: Compiled from Sri Lanka Customs Database

been high (20 percent over the past 5 years) resulting in imports of US\$ 2019 million in 2006, which accounted for 21 percent of Sri Lanka's total imports (Chart 3). Of this, just over US\$ 1800 million were from India, accounting for 89 percent of imports from the BIMSTEC and 18 percent of Sri Lanka's total imports from the world. India was Sri Lanka's largest source of imports in 2006 (followed by Singapore, China, and Hong Kong). Similar to the trend in exports, the increase in imports from BIMSTEC has been in parallel to the increase in imports from India as a result of the ILFTA. In 2006, Sri Lanka imported 9 times more from India than Thailand, the second highest source of imports from region with a share of 10 percent while imports from the remaining BIMSTEC members (Bangladesh, Bhutan, Myanmar and Nepal) were negligible (accounting for less than 1 percent of Sri Lanka's total imports in 2006).

In terms of composition of imports from the region, the main imports from the region are: mineral products (23 percent), transport equipment (17 percent), textile and textile articles (11 percent) and

Chart 3: Imports from BIMSTEC & Japan to Sri Lanka (2002-06)



Note: Bhutan, Thailand, Bangladesh, Myanmar, Nepal right axis.

Table 8: Sri Lanka's Imports (section-wise) from BIMSTEC (% of Country Imports) 2006

Description	Bangladesh	India	Myanmar	Nepal	Thailand	ALL
I Live animals and products	0.00	0.55	0.00	0.00	11.41	1.64
II Vegetable products	0.84	5.50	26.68	0.00	1.85	5.15
III Fats and oils	0.00	0.45	0.00	0.00	0.02	0.41
IV Prepared foodstuffs, beverages, etc.	0.00	4.24	0.00	0.00	9.13	4.70
V Mineral products	0.00	24.47	0.00	0.00	8.42	22.73
VI Chemical products	11.57	8.89	0.00	0.00	8.30	8.83
VII Plastics and rubber	2.84	3.83	0.00	14.90	10.68	4.51
VIII Hides and skins, leather, etc.	0.58	0.06	0.00	37.85	0.16	0.07
IX Wood and articles of wood	0.09	0.28	17.22	0.00	1.23	0.40
X Pulp of wood, paper, books, etc.	0.61	3.43	0.00	2.29	1.39	3.21
XI Textiles and textile articles	48.83	9.62	0.00	0.00	24.42	11.25
XII Footwear, headgear, umbrellas, etc.	0.83	0.11	0.00	0.00	0.48	0.15
XIII Articles of stone, cement, etc.	0.14	0.91	0.40	0.00	2.26	1.04
XIV Precious stones, etc.	0.00	0.16	54.76	0.00	1.00	0.32
XV Base metals and products	30.50	11.58	0.75	0.00	4.20	10.90
XVI Machinery and electrical equipment	2.77	6.26	0.08	0.00	11.68	6.78
XVII Transport equipment	0.28	18.77	0.00	27.63	2.53	17.03
XVIII Optical and precision instruments	0.04	0.59	0.10	0.00	0.14	0.54
XIX Arms and ammunition	0.00	0.00	0.00	0.00	0.00	0.00
XX Miscellaneous manufact. Articles	0.08	0.30	0.00	17.33	0.65	0.33
XXI Works of art, etc.	0.00	0.00	0.00	0.00	0.05	0.01
XXII Baggage office, parcel post and re-imports	0.00	0.00	0.00	0.00	0.00	0.00
Total	100.00	100.00	100.00	100.00	100.00	100.00
Value (US\$ mn)	7.99	1805.20	2.84	0.07	202.96	2016.22

Source: Compiled from Sri Lanka Customs Database

Table 9: Sri Lankan Imports from BIMSTEC (% of Sector) 2006

Description	Bangladesh	India	Myanmar	Nepal	Thailand	ALL
I Live animals and products	0.00	4.12	0.00	0.00	9.57	13.68
II Vegetable products	0.02	24.28	0.18	0.00	0.92	25.40
III Fats and oils	0.00	5.11	0.00	0.00	0.03	5.14
IV Prepared foodstuffs, beverages, etc.	0.00	18.50	0.00	0.00	4.48	22.99
V Mineral products	0.00	24.13	0.00	0.00	0.93	25.07
VI Chemical products	0.13	23.18	0.00	0.00	2.43	25.75
VII Plastics and rubber	0.05	14.37	0.00	0.00	4.51	18.92
VIII Hides and skins, leather, etc.	0.26	6.23	0.00	0.15	1.75	8.38
IX Wood and articles of wood	0.02	10.48	1.01	0.00	5.19	16.70
X Pulp of wood, paper, books, etc.	0.02	21.80	0.00	0.00	0.99	22.81
XI Textiles and textile articles	0.24	10.50	0.00	0.00	2.99	13.73
XII Footwear, headgear, umbrellas, etc.	0.43	12.23	0.00	0.00	6.19	18.84
XIII Articles of stone, cement, etc.	0.01	21.20	0.01	0.00	5.93	27.16
XIV Precious stones, etc.	0.00	0.91	0.48	0.00	0.63	2.02
XV Base metals and products	0.33	27.93	0.00	0.00	1.14	29.39
XVI Machinery and electrical equipment	0.02	7.89	0.00	0.00	1.66	9.56
XVII Transport equipment	0.00	45.95	0.00	0.00	0.70	46.65
XVIII Optical and precision instruments	0.00	11.16	0.00	0.00	0.30	11.47
XIX Arms and ammunition	0.00	0.00	0.00	0.00	0.00	0.00
XX Miscellaneous manufact. Articles	0.01	5.28	0.00	0.01	1.28	6.58
XXI Works of art, etc.	0.00	5.94	0.00	0.00	71.15	77.08
XXII Baggage office, parcel post and re-imports	0.00	0.01	0.00	0.00	0.00	0.01
Total	0.08	18.47	0.03	0.00	2.08	20.65

Source: Compiled from Sri Lanka Customs Database

base metals (10.9 percent), which are mainly sourced from India. BIMSTEC as a region is also an important source of imports to Sri Lanka in a number of sectors: works of art, transport equipment, base metals, articles of stone, mineral products, chemical products, vegetable products, prepared foodstuff, to name a few.

3.2 Investment

In terms of investments from the BIMSTEC region, India figures prominently as a foreign direct investor in Sri Lanka, followed by Thailand and to a small extent Bangladesh. India is now amongst the top 5 foreign investors in the country with a total number of 164 Indian projects as the end of 2006 according to the BOI with an estimated valued of Rs. 32.7bn (under section 17 of the BOI Law)⁶, accounting for about 7 percent of total investments to date. From India's point of view, Sri Lanka has been an important destination for FDI in South Asia, with over 50 percent of Indian joint venture and wholly-owned subsidiaries in the South Asian region located in Sri Lanka. The inflow of direct investment from India began back in the 1980s with the liberalization of the Sri Lankan economy while the signing of the ILFTA gave a further push for Indian companies to invest in Sri Lanka with a view to export to the Indian market. Most of the Indian investments to date have gone into the services sector (66 percent), followed by food products (11 percent) and fabricated metal products (10). Comparatively, Thailand's investments in Sri Lanka are much smaller with 5 projects to date, namely in jewellery and lapidary, services and apparel, which together amounted to less than Rs.200mn.

3.3 Services

Sri Lanka's trade in services with BIMSTEC partners is due to its trade in services with India. There is also services trade, but to a lesser extent with Thailand and Bangladesh. The major services that Sri Lanka is engaged with other BIMSTEC countries are in: port related activities, air transport, tourism, health and education services and retail. Most of this trade in services occurs through foreign direct investments (Mode 4), with Indian investment in Sri Lankan service sectors dominating the sectors.

India has invested Rs. 17.3 billion in Sri Lanka through 54 service related investments (under the Board of Investment Acts 16 and 17) as of 2006. Thailand was involved in two service related investments during the same period, with a realized investment of Rs. 23.3 million. Some of the major Indian investments in Sri Lanka includes: Apollo hospital (health services), Indian Oil Corporation (retail), Taj hotels (tourism), Jet Airways, Sahara and Indian airlines (air services) and ICICI Bank (financial services). It is clear that trade in services is very significant between Sri Lanka and India through FDI, and this is likely to be further enhanced as the two countries complete a Comprehensive Economic Partnership Agreement (CEPA) which includes an agreement on services aimed at removing barriers to trade in services.

Besides FDI, Sri Lanka engages in trade in services with India across other modes, particularly Mode 2 (consumption abroad). Large proportion of Colombo's port activity is related to transshipment between the East and West coast of India (this includes Bangladeshi vessels). In the year 2006, income from transportation services increased by 11.6 percent, led to a great extent by increased volume of transshipment cargo handling, which grew by 37 percent reflecting India's expanding international trade and economic growth⁷. Given India's continued economic expansion it is likely that this trade will continue to grow despite competition from Southern Indian ports in Kerala and Tamil Nadu.

Air services between the countries continue to grow while the national carrier, Sri Lankan airlines has secured a number of destinations in India during 2006. In fact, today Sri Lanka has the greatest access to destinations in India with 95 flights a week. As trade in services between the two countries continues to expand in volume and scope it is likely that passenger air travel between the countries will grow simultaneously. Related to air services, tourism is a major source of trade in services in Sri Lanka, and India dominates tourist arrivals to Sri Lanka. In 2006, out of 559,603 tourist arrivals to the island, 128,370 were from India, the largest amount from a single country. Sri Lanka and Thailand have also an open skies policy between the two countries, allowing Sri Lankan airlines to travel

between Colombo and certain other cities (Beijing and Hong Kong for instance) via Bangkok, picking up passengers in the latter. The final significant source of trade in services between India and Sri Lanka is in Mode 2, namely education services as many Sri Lankan students travel to India for higher education as there are few vacancies available in Sri Lankan universities.

Given that Sri Lanka is on the brink of a services agreement with India, its major services partner in BIMSTEC, and trade in services is likely to be included in the SAFTA (including Bangladesh, Nepal and Bhutan), a services agreement in BIMSTEC diminishes in value from a Sri Lankan perspective. However, if a meaningful agreement can be reached it is entirely possible that new, previously unexploited trading opportunities could be opened within the region, making other BIMSTEC countries more relevant trading partners to Sri Lanka. An example of such an instance was the export of *Vanaspathi* from Sri Lanka following the FTA with India. In the past *Vanaspathi* was not a major export item from Sri Lanka. However, the FTA provided a new opportunity which resulted in increased exports from Sri Lanka to India and increased investment into Sri Lanka, both from India and third countries. Today *Vanaspathi* is the major export item from Sri Lanka to India.

4. Importance of Japan to BIMSTEC and Sri Lanka

The importance of Japan as a trading partner varies across countries in the region but on the whole Japan is an important trading partner, both as a source of imports and destination of exports, particularly for Thailand. In fact, Japan is the second largest export market after the US and largest single source of imports to the country, accounting for 22 percent of Thailand's total imports. Much of the trade between the BIMSTEC region and Japan is largely due to substantial bilateral trade between Japan and Thailand and to a lesser degree India. In terms of imports to region, Thailand accounts for about 85 percent of total imports of BIMSTEC from Japan, followed by India, accounting for 11 percent. The same is true of exports from the region to Japan – Thailand accounts for 84 percent of total exports of the region to Japan while India has a share of 13 percent. From Japan's point of

view, the BIMSTEC region accounts for less than 5 percent of its exports and imports, with Thailand accounting for much of this trade.

Japan is also an important source of foreign direct investment. Asia was the third largest recipient of Japanese FDI with a share of 18 percent, after the US and Europe. Presence of Japanese investments have been particularly strong in ASEAN (especially amongst the NIEs of the region), which received 9.2 percent of total Japanese investments, while China (including Hong Kong) has emerged as attractive destination in Asia. While Japanese direct investments contributed substantially to establishing closer relations between Japan and East Asia, the role played by Japan in the BIMSTEC region other than Thailand, has so far been negligible. BIMSTEC as a region has only managed to receive 2.6 percent of cumulative Japanese FDI over the last 5 years. Furthermore, the major part of this FDI to region has gone to Thailand, which accounts for over 82 percent of Japanese FDI to the group followed by India with a share of 16 percent. South Asia as a region and Myanmar have not been major recipient of Japanese FDI, compared to ASEAN due to their slower economic growth, poor infrastructure, extensive government restrictions, labour problems which deterred Japanese investments into these countries in the past. But, the situation is fast changing with the opening of these economies and Japan is increasingly looking at India as a new investment destination.

Bilateral services trade between BIMSTEC and Japan appears to be quite low at the moment. In the case of Thailand and India for which there is data on trade in services with Japan, both countries have a very small share of Japan's total commercial services (about 3 percent between the two countries) and the value of commercial services has been stagnant.

4.1 Importance of Japan to Sri Lanka in terms of trade in Goods

Japan's ranking as an export market of Sri Lanka has fallen over the years from the third largest export market in 2000 to ninth place with the emergence of other trading partners. A similar

Table 10: Top 10 Exports to Japan, 2006

HS	Description	US\$ mn	% of total exports
09	Coffee, tea, mate & spices	35.73	21.84
03	Fish and crustaceans, molluscs and other aquatic invertebrates	30.07	18.38
40	Rubber & articles thereof	18.00	11.00
71	Natural or cultured pearls, precious or semi-precious stones, etc.	11.00	6.73
90	Optical, photographic, etc. instruments and accessories	7.14	4.36
62	Articles of apparel and clothing accessories, not knitted or crocheted	6.85	4.19
61	Articles of apparel and clothing accessories, knitted or crocheted	6.77	4.14
53	Other vegetable textile fibres; paper yarn and woven fabrics	6.35	3.88
96	Miscellaneous manufactured articles	6.02	3.68
85	Electrical machinery and equipment and parts thereof	5.73	3.50

Source: Sri Lanka Customs Database

picture appears on the import side with its ranking as a source of imports dropping to sixth place from being the single largest import country in 2000. Exports to Japan has been stagnant over the past five years (recording a negative growth rate for the whole period 2002-05) and reached a value of US\$ 162 mn in 2006 (Chart 2). On the other hand, imports from Japan have performed better (growing at a rate of 6 percent) with Sri Lanka importing goods valued at US\$ 450mn in 2006 (Chart 3), further widening the trade deficit in favour of Japan (from US\$ 217.46mn recorded in 2002 to US\$ 286.8mn by 2006). Japan currently accounts for 2.4 percent of Sri Lanka's export and 4.6 percent of the country's imports. Its share in Sri Lanka trade has almost halved since 2000 – Japan accounted for 4.1 and 8.8 percent of Sri Lanka's exports and imports respectively in 2000.

Main export sectors to Japan include vegetable products (tea), live animals and products (fish and crustaceans), rubber and articles, textiles and textile articles, precious/semi-precious stones, which together accounted for more than half of Sri Lanka's total exports to Japan (Table 11). In fact, Japan is an important export market for tea, and accounts for about one-fifth of Sri Lanka's total tea exports to the world. The main imports from Japan are: transport equipment (vehicles), which alone account for half of Sri Lanka's imports from Japan, followed by machinery and mechanical appliances. In fact, import of transport equipment from Japan accounts for about one-fourth of Sri Lanka's total imports of the item from the world.

4.2 Importance of Japan to Sri Lanka in terms of investments

The beginning of Japanese foreign direct investments in Sri Lanka dates back to 1972, with the establishment of a joint venture between Noritake of Japan and the Ceylon Ceramics Corporation. Since then Japanese investments in Sri Lanka have contributed to the industrial development of the country, namely in sectors such as electronics, ceramics, engineering and metal-based sectors. Currently, Japan ranks amongst the top 10 investors in Sri Lanka, with a cumulative value of

Table 11: Top 10 Imports from Japan, 2006

HS	Description	US\$ mn	% of total imports
87	Vehicles other than railway or tramway rolling-stock, parts etc.	245.76	54.66
84	Nuclear reactors, boilers, machinery and mechanical appliances, etc.	67.32	14.97
85	Electrical machinery and equipment and parts thereof, etc.	25.32	5.63
39	Plastics and articles thereof	17.40	3.87
55	Man-made staple fibres	10.93	2.43
90	Optical, photographic, etc. instruments and accessories	10.10	2.25
73	Articles of iron or steel	9.25	2.06
40	Rubber & articles thereof	7.47	1.66
60	Knitted or crocheted fabrics	6.80	1.51
72	Iron and steel	5.87	1.31

Source: Sri Lanka Customs Database

investments of Sri Lankan Rs. 17bn (accounting for about 4 percent of total FDI to Sri Lanka) with 66 enterprises operating as of end 2006 (under the section 17 of the BOI Law)⁸. From Japan's point of view, the flow of Japanese investments into Sri Lanka has been low – FDI flows from Japan to Sri Lanka failed to rise to even to 1 percent of total Japanese FDI. Despite attempts to attract FDI to Sri Lanka with generous incentives offered by the Sri Lankan government, the volume of flows in general and Japanese investments in particular has been low in scale and character. This has been due to a number of factors including poor resource endowments, low rate of economic growth, political and social unrest in the country and underdeveloped domestic capital market and poor industrial environment (Lakshman and Ratnayake, 2003).

Much of the Japanese investments (in terms of value) has been in services sector and account for 61 percent of total investments⁹. While most of the initial investments were small- and medium-scale ventures, few large multinational conglomerates such as NTT, Mitsui Group, Kawasho Corporation, and YKK have committed substantial investments in large infrastructure and manufacturing projects. But on the whole the majority of the Japanese investments in Sri Lanka have been small size in terms of volume of investment. Some of the other major Japanese investments in Sri Lanka include JICA, Noritake, FDK, to name a few.

4.3 Importance of Japan to Sri Lanka as a Donor

Government of Japan has been a key lending partner of Sri Lanka ever since the two countries commenced diplomatic relations back in 1952. The present focus of Japanese ODA has been in support of peace building and in economic and social infrastructure, institutional reform, measures for acquisition of foreign currency and poverty alleviation¹⁰. Japanese aid to Sri Lanka is channeled through JICA (Japanese International Cooperation Agency), JBIC (Japan Bank for International Cooperation) and one can not ignore Japan's contribution to the ADB. The vast majority of Japanese aid has been untied and at a concessional rate. Furthermore the aid has very closely tracked the key development challenges in Sri Lanka, focusing on issues such as

**Table 12: Realised Investments from Japan as at end 2006
(Approved under section 17 of the BOI Law)**

	No. of Projects	Actual Investment (Rs.Mn.)		Total
		Foreign	Local	
Beverages & Tobacco	1	11.8	0.0	11.8
Coir Products	2	30.7	9.0	39.7
Electronic & Electrical Goods	5	1,328.3	7.1	1,335.4
Fabricated Metal Products	4	89.3	1.5	90.8
Food Products (Processing)	4	233.6	194.8	428.3
Horticulture	4	110.6	25.1	135.7
Ind.,Chemical,Petroleum,Coal & Plastic	2	93.1	5.3	98.4
Jewellery & Lapidary	3	342.7	11.5	354.2
Marine/Fishing Gear & Accessories				
Non-Metallic Mineral Products	5	1,014.7	697.3	1,711.9
Other Manufactured Products (N.E.S.)	3	362.9	0.0	362.9
Paper & Paper Products				
PVC Products	1	154.0	0.0	154.0
Rubber Products	4	875.3	49.1	924.4
Services	16	8,746.7	1,557.3	10,304.1
Transport Equipment	5	285.9	7.4	293.4
Textiles & Fabrics				
Wearing Apparel (Excluding Leather Gar.)	6	125.0	36.9	161.9
Wood Products	1	535.0	0.0	535.0
Total	66	14,339.7	2,602.3	16,941.9

Source: Board of Investment, Sri Lanka

physical infrastructure, conflict, rural inequalities and the energy sector.

Japanese ODA consists of loans, grants and technical assistance. JBIC's assistance is dominated by untied concessionary loans, while JICA's funding consists of a mix of loans, grants and TA. In 2005 Japan provided 1.1 Billion Yen worth of grants to Sri Lanka and 30 Billion Yen in loans, and as of 2004, 6044 Sri Lankan citizens have been received as trainees by the Government of Japan and 1172 Japanese technical consultants have been dispersed to work in Sri Lanka. As per capita income has increased, there is less access to concessional funding available to Sri Lanka from multilateral donors. Furthermore, certain countries have reduced aid allocations due to a lack of progress in peace efforts in the country. Japan on the other hand has scaled up aid efforts and has continued to lend to Sri Lanka despite the adverse climate. Given this long and successful history, Sri Lanka has a close relationship with Japan as a donor and as a country.

5. What are the Potential Opportunities and Challenges of Enlarging BIMSTEC to Include Japan for Sri Lanka?

Having examined the present status of Sri Lanka's trade relations between BIMSTEC and Japan it is pertinent to consider the possible opportunities and challenges that will arise if Japan joins BIMSTEC. This section will first consider the opportunities and challenges with regard to specific sectors – goods, services and investment – followed by a discussion on more general challenges that come about due to North-South regional trade arrangements. This section will also discuss what needs to be done by BIMSTEC to attract new members such as Japan.

5.1 Opportunities and Challenges for Increased Trade in Goods

While intra-regional trade in the region currently remains low (i.e.) less than 5 percent of the region's trade, inclusion of Japan would increase this figure modestly to about 7 percent. The scope for further expansion of trade could be greater if there is closer cooperation in

trade between the region and Japan given the trade complementarities in the enlarged BIMSTEC.

Revealed comparative advantage (RCA) index, which is commonly used to gauge the potential for intra-regional trade, indicates that countries in the region have comparative advantage in similar products except in the case of India and Thailand and as such the potential for trade expansion within the BIMSTEC may be modest (Table 13). Inclusion of Japan could further enhance the complementarities in the region given that Japan's comparative advantage lies in different set of goods, which almost none of the BIMSTEC countries (other than India and Thailand) display. This is very evident in the case of Sri Lanka. Sri Lanka's comparative advantage lies in textiles and textile articles, vegetable products, precious stones, plastics and rubber, live animals and animal products while Japan's comparative advantage is in transport equipment, optical and precision instruments, machinery and electrical equipment, and base metals, providing much scope for bilateral trade expansion.

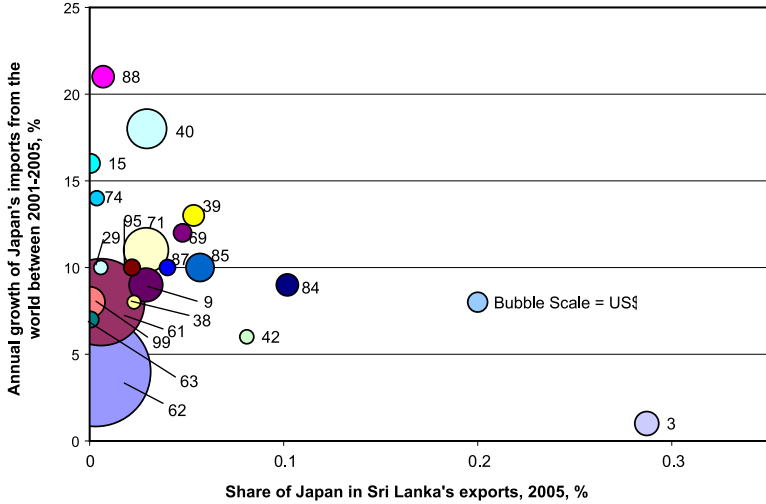
Chart 3 shows potential trade¹¹ between Sri Lanka and Japan in terms of sectors (at HS 2 digit level). The annual growth of Japan's imports from the world is plotted on the vertical axis and the share of the Japan in Sri Lanka's exports is plotted on the horizontal, while the size of the bubbles represents the size of the potential trade between the two countries. Reflecting the comparative advantage of Sri Lanka in textiles and textile articles, the chart shows that the highest potential for trade lies in the export of textiles and textile articles from Sri Lanka to Japan. Despite the fact that the sector accounts for more than half of Sri Lanka's total exports, less than one percent of the exports go to Japan and as such the Japanese market remains unexploited. However, it should be noted that this sector records comparatively lower growth in terms of imports from Japan. After textiles and textile articles, plastics and rubber, and precious stones record the highest potential in terms of exports to Japan. As it can be seen from the Chart, these sectors also record high import growth in Japan – the growth rate over the last 5 years is high as 18 percent in the case of rubber. Vegetable products (namely coffee, tea, mate and

Table 13: RCA Indices for BIMSTEC+Japan, 2003

Description	BG	IN	NP	SL	TH	JP
I Live animals and products	2.6	1.4	0.2	1.1	1.6	0.1
II Vegetable products	0.2	2.8	2.6	7.6	1.6	0.0
III Fats and oils	0.0	0.9	24.5	0.5	0.5	0.0
IV Prepared foodstuffs, beverages, etc.	0.1	0.9	1.8	0.6	2.5	0.1
V Mineral products	0.0	1.0	0.1	0.0	0.4	0.0
VI Chemical products	0.1	1.1	0.7	0.1	0.3	0.7
VII Plastics and rubber	0.0	0.7	0.7	1.5	2.3	1.0
VIII Hides and skins, leather, etc.	3.3	3.1	1.8	1.0	1.0	0.1
IX Wood and articles of wood	0.1	0.1	0.6	0.4	0.9	0.0
X Pulp of wood, paper, books, etc.	0.1	0.2	0.8	0.3	0.5	0.3
XI Textiles and textile articles	15.2	3.7	9.0	9.4	1.2	0.3
XII Footwear, headgear, umbrellas, etc.	1.5	1.6	0.9	1.1	1.4	0.0
XIII Articles of stone, cement, etc.	0.2	1.0	0.1	0.8	1.1	0.9
XIV Precious stones, etc.	0.0	8.9	0.3	2.5	1.7	0.2
XV Base metals and products	0.0	1.4	1.6	0.5	0.6	1.0
XVI Machinery and electrical equipment	0.0	0.2	0.0	0.1	1.3	1.5
XVII Transport equipment	0.0	0.2	0.0	0.2	0.5	1.9
XVIII Optical and precision instruments	0.1	0.2	0.0	0.1	0.6	1.7
XX Miscellaneous manufact. Articles	0.1	0.1	0.0	0.0	0.0	0.2
XXI Works of art, etc.	0.1	0.3	0.3	0.5	1.0	0.4
XXII Petroleum Products	0.0	0.6	0.2	0.0	0.7	1.3

Source: Computed from using COMTRADE Database

Chart 3: Potential Trade between Sri Lanka and Japan in 2005 ('000)



Codes:

- 03 Fish, crustaceans, molluscs, aquatic invertebrates nes
- 09 Coffee, tea, mate and spices
- 15 Animal, vegetable fats and oils, cleavage products, etc
- 29 Organic chemicals
- 38 Miscellaneous chemical products
- 39 Plastics and articles thereof
- 40 Rubber and articles thereof
- 42 Articles of leather, animal gut, harness, travel goods
- 61 Articles of apparel, accessories, knit or crochet
- 62 Articles of apparel, accessories, not knit or crochet
- 63 Other made textile articles, sets, worn clothing etc
- 69 Ceramic products
- 71 Pearls, precious stones, metals, coins, etc
- 74 Copper and articles thereof
- 84 Nuclear reactors, boilers, machinery, etc
- 85 Electrical, electronic equipment
- 87 Vehicles other than railway, tramway
- 88 Aircraft, spacecraft, and parts thereof
- 95 Toys, games, sports requisites
- 99 Commodities not elsewhere specified

Note: Trade potential is defined as the lower value of the amount a market exports (imports) to the world and the amount the partner country imports (exports) from the world, minus the existing trade between the two countries under review.

Source: ITC Trade Map

spices), live animals (fish, crustaceans, molluscs, aquatic invertebrates) also shows high potential for trade with Japan.

Bhattacharya and Bhattacharya (2006) measured the impact of a preferential trading arrangement between BIMSTEC and Japan by applying the Srinivasan and Canonero gravity model¹² developed specifically for South Asian countries between 1993-1997. They carried out a comparative static analysis of tariff reductions under four different scenarios and calculated the increase in imports and exports of both Japan and BIMSTEC countries. The hypothetical cuts in tariffs were: 25 percent, 50 percent and 75 percent along with a complete Free Trade Area (i.e. 100 percent elimination of tariffs). An average (weighted) tariff for all countries was used, based on data gathered in 2003¹³. It was found that countries with initially high tariff rates saw an increase in imports – both in absolute and percentage values – under an FTA which was much higher than the increase in exports relative to countries with low tariff rates. Under a FTA with BIMSTEC, Japan's growth in exports to BIMSTEC countries (US\$ 13,821.2mn) exceeded by far its growth in imports (US\$ 1,341.4mn) and hence it would be the largest beneficiary of a free trade arrangement with the BIMSTEC. Consequently, all BIMSTEC countries recorded a trade deficit with Japan. In case of Sri Lanka, exports rose by US\$ 18mn while imports rose by 7 times as much (US\$ 121mn), worsening the trade balance with Japan by US\$ 103mn. However, a trade deficit may not be necessarily a bad thing if it results in an improvement in welfare of the country.¹⁴

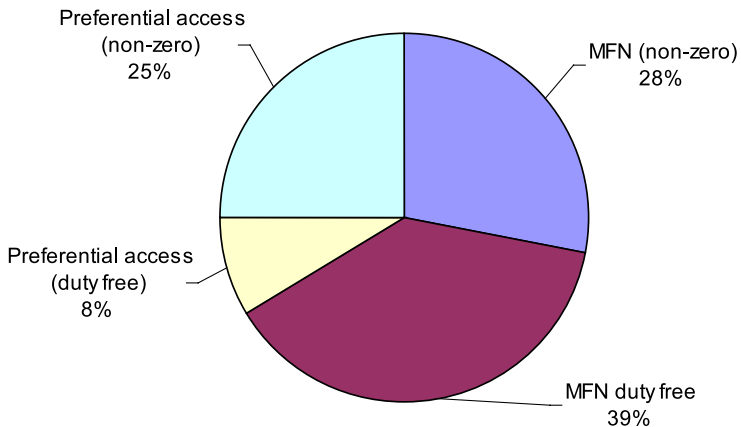
The empirical evidence suggests there is potential for increased exports to Japan if trade is liberalized between Sri Lanka and Japan under an FTA. However, certain caveats need to be kept in mind, in particular the existing levels of market access enjoyed by Sri Lanka and the extent of non-tariff barriers in Japan – if both are high the potential for gain through a FTA is reduced.

a) Market Access Conditions in Japan for Sri Lankan goods - In order to predict the potential for gain through liberalization of trade with Japan, it is necessary to examine the extent of duty free access that Sri Lanka already enjoys in Japan. Japan's primary trade

instrument is the tariff. These are relatively low - in 2006, the simple average MFN tariff was 6.5 percent. Almost all tariffs (99 percent) are bound, and the applied rates in general coincide with the bound rate. Fisheries are major unbound items that maybe of interest in terms of negotiating a regional deal with Japan. However, it should be taken into account that *non-ad valorem* duties play an important role, particularly in agriculture. These account for 6.7 percent of all tariff lines and involve high *ad valorem* equivalents. Some 1.7 percent of all Japan's tariff lines are subject to tariff rate quotas. While 100 percent of the in-quota rates are *ad valorem*, only 25.3 percent of out-of-quota rates are *ad valorem*.

Chart 4 below shows the market access conditions in Japan for Sri Lanka. About 39 percent of the tariff lines are MFN duty free, while 28 percent of the tariff lines are non-zero on a MFN basis. Sri Lanka also receives duty free access to Japan under its GSP scheme, accounting for 8 percent of the tariff lines. Further 25 percent of the tariff lines receive preferential treatment or duty concessions under the GSP scheme. All in all, Sri Lanka has duty free and preferential

**Chart 4: Market Access Conditions in Japan for Sri Lanka
(by Tariff Lines)**



Source: Compiled from MacMap Database

access to 72 percent of the tariff lines (47 percent duty free and 25 percent under preferential non-zero terms), which implies that Sri Lanka already has relatively good market access conditions to Japan. In terms of value of imports, currently about half of Japan's imports from Sri Lanka are duty free, indicating that Sri Lanka does not stand to gain a great deal from an FTA with Japan since trade between the two countries is already relatively liberal.

b) Japan's Non-Tariff Barriers - Japan uses very few non-tariff barriers to trade but there remain certain prohibitions, quantitative restrictions and licensing requirements intended to protect health, environmental and security interests.

c) Quotas - Import quotas are imposed on various items, including certain fish products, certain organic chemicals, pharmaceuticals, explosives, nuclear goods, certain animals and plants, controlled substances, alcohol, and items containing asbestos, amosite, and crocidolite. Of particular interest to Sri Lanka in this context is the restriction placed on certain fish products which may restrict Sri Lanka's ability to export certain types of fish to Japan.

d) Standards - Products imported into Japan are also subjected to a mixture of voluntary and mandatory standards, failure to adhere to which may disqualify a product from sale in Japan. However, compliance with voluntary standards can provide a large boost to the product's sale potential in Japan¹⁵.

e) Sanitary and Phyto-Sanitary (SPS) Measures - Whilst Japan imposes quarantine regulations targeting diseases, most of these do not adversely affect Sri Lankan exports. Some of the other SPS measures may however have impacts on Sri Lankan exports in the future. Japan currently imposes import prohibitions on beef and poultry from various countries due to BSE and avian flu. The Food Safety Commission has been conducting safety assessments of genetically modified foods (GM food) since 2003. Certain apparel exports are also subject to restrictions under the Convention on International Trade in Endangered Species (CITES), particularly those utilising fur or

leather. There are also restrictions on components of textiles such as formalin. Product safety laws are applicable to many household appliances and furniture requiring labeling.

5.2 Opportunities and Challenges for Trade in Services

Sri Lanka's interest in trade in services is mainly in export through Mode 4 and Mode 1 and import through Mode 3. Given Sri Lanka's comparative advantage in labour at various skill levels, these two modes become particularly important to the country's interest. Sri Lanka has therefore been keen on greater access to markets for services. However GATS has been a disappointment - Mode 4 remains the most protected of the four modes, and there has been a trend towards protectionism in Mode 1 as well¹⁶. Therefore Sri Lanka has pursued regional and bilateral trade agreements which include the liberalization of services. Besides BIMSTEC, the Sri Lanka-India CEPA includes the liberalization of services and the South Asian Free Trade Agreement is also likely to include trade in services. The possible inclusion of Japan in BIMSTEC enhances opportunities for trade in services for Sri Lanka.

Remittances from temporary migrants play an important role in Sri Lanka's economy bridging deficits in the Balance of Payments current account. In this context, Sri Lanka had been seeking increased market access in the developed world in particular for temporary migrants in skilled, semi skilled and unskilled labour. Given Japan's ageing population there are gaps in the labour market that could be filled by temporary migrants at many skills levels. This labour market situation also contributes to higher wages available to workers. Another consequence of Japan's ageing population is a demand for specific health care such as home nursing. Whilst many South East Asian countries have already exported nurses to Japan, there could yet be opportunities for countries like Sri Lanka to do so if preferential conditions are obtained. Japan's GATS commitments are not very liberal in Mode 4, with the majority of scheduled sectors leaving mode 4 unbound. Sri Lanka also has a large pool of qualified professionals in fields such as accounting, legal services and so on. This provides scope for export of services through Mode 1. Japan has already

Table 14: Revealed Comparative Advantage in Services: BIMSTEC and Japan

	Commercial Services		Transport		Travel		Other Services	
	1999	2003	1999	2003	1999	2003	1999	2003
Bangladesh	0.2	0.3	1.5	0.8	0.6	0.5	1.0	1.4
India	1.4	1.4	0.6	0.6	0.7	0.6	1.5	1.4
Japan	0.7	0.7	1.7	1.6	0.2	0.4	1.3	1.1
Myanmar	1.4	0.4	0.7	1.3	1.2	0.8	1.0	0.8
Nepal	2.1	1.5	0.5	0.5	1.2	2.3	1.1	0.5
Sri Lanka	0.9	1.1	1.9	1.8	0.9	1.1	0.6	0.6
Thailand	1.0	0.8	0.9	1.0	1.5	1.7	0.7	0.6

Source: Calculated using IMF BoP CD-ROM

scheduled professional services under GATS, however there remain some restrictions in the schedules including certain qualifications under Japanese law. However two significant qualifications must be made with regard to the potential for trade in services between Sri Lanka and Japan. Trade in services through Mode 4 and many components of Mode 1 between the two countries will be compromised by significant language barriers. Whilst English is the common language between the two countries, an inability to converse in Japanese will be a significant disadvantage to Sri Lankan service suppliers. Secondly, it is unlikely that Sri Lankan service suppliers will meet all the qualification requirements in the Japanese services market. This relates particularly to Mode 4 professionals. There will be a need for Mutual Recognition Agreements (MRAs) between the relevant professional bodies, and possibly a need for additional qualifications, resulting in an increased cost for service suppliers from Sri Lanka hoping to work in Japan. In Japan's GATS commitments, most professional services require special Japanese qualifications – i.e. Lawyers require Japanese “Bengoshi” qualifications, accountants require Japanese “Koninkaikeishi” qualifications and architects require Japanese “Kenchikushi” qualifications.

In terms of import of services, Sri Lanka stands to benefit from increased Japanese investment in the Sri Lankan services sector. Japan has already played an important role in Mode 3 exports to Sri Lanka, particularly in sectors such as telecommunications and maritime services. Japan has been interested in the export of services through Mode 3, particularly in sub-sectors such as telecommunications, distribution, construction, maritime, financial and computer related services sectors. Japan is therefore likely to seek liberalization of Mode 3 in these areas. Japanese investment in many of these areas would be beneficial to Sri Lanka, particularly telecommunications infrastructure, construction, maritime services and computer related services. Increased foreign participation will increase dynamism in these sectors and will in all probability have positive spill over impacts on other sectors of the economy as well. At the same time it should be noted that Sri Lanka has a liberal attitude towards foreign investment, and it is unlikely that a BIMSTEC agreement on services will make more

than a marginal difference in terms of attracting investments in the services sector.

5.3 Opportunities and Challenges for Increasing Investments

The inclusion of Japan would enlarge the market of the BIMSTEC region, and this could potentially attract market seeking investments from Japan or third countries outside the region to locate in any of the BIMSTEC countries with a view to accessing regional market. But potential investment flows to Sri Lanka as a result of the enlarged BIMSTEC may be limited for a number of reasons.

First, investors who would want to access the BIMSTEC market would most likely locate in either India or Thailand, which are currently the largest markets and recipients of FDI including Japanese FDI in the region. In fact, Japan is keen to invest in India and make it a hub for production and exports to Europe and (West) Asia. Second, investors that want to access India through Sri Lanka can already do so under Indo-Lanka Free Trade Agreement. Moreover, CEPA negotiations currently underway would also include an investment agreement and this would be in place by the end of 2007. Third, it is unlikely that investors would consider Sri Lanka in their decisions to investment in order to access Thailand given that it offers a better environment for investments in the region. Fourth, Japanese investors already have access to Thailand under the Economic Partnership Agreement signed in 2007 and would have similar access to India under the EPA with Japan which is expected to be signed in the near future. Fifth, no trade agreement would attract FDI to the country if the domestic situation in Sri Lanka does not improve. According to a survey of opinions of Japanese investors by JETRO with regard to investment environment in Sri Lanka the following issues were highlighted as problematic :uncertainty regarding peace and security, lack of policy continuity caused by political instability, lengthy dispute settlement procedures, inefficient customs procedures, underdeveloped infrastructure, deficient labour laws and regulations and frequent labour disputes (Ebashi, 2006). If these domestic concerns remain unaddressed, a regional investment agreement with Japan is not likely make Sri Lanka any more attractive than it is at present.

5.4 Other Challenges

Standards – The biggest challenge that arises is due to the significant variation in the standards in both goods and services. In developing countries the product quality, safety, environmental standards are often lower than those expected in more developed partners. This is expected since the demands and preferences of consumers in developed and developing nations will be different. For instance, in a more advanced country consumers will be willing to pay more to ensure that a product is environmentally friendly, whereas this is less likely in a developing nation. As a result, market access into the “Northern” partner maybe undermined if the products of developing nations do not satisfy their requirements. In order to mitigate this problem, there needs to be an upgrading of the standards of products of the “Southern” partners. This can incur costs as it will require new testing mechanisms to certify standards. Furthermore, a first best scenario would see attempts are harmonisation of standards across the board in order to facilitate the cross border movement of goods. In such situations when there are vast differences in levels of development, harmonisation becomes even more challenging. Failure to harmonise within the region will increase transactions costs to trade. The same applies to trade in services, where the qualifications of professionals will be expected to be higher in developed nations. In this context it is likely that Japan may not recognize qualifications provided by many of the BIMSTEC nations. Therefore, we need to have MRAs in BIMSTEC and with Japan.

Structure of the Agreement – Developing countries are in general more cautious in their approach to the liberalisation of trade. Due to greater market imperfections in the form of rigid factor markets, imperfect information, credit and land markets, adjustment costs of liberalisation are in general higher in less developed economies. Furthermore due to the relative immaturity of many industries and services, developing nations are keen on a more measured liberalisation of markets. Therefore, many South-South agreements are characterised by larger negative lists, liberal rules of origin requirements and longer phasing out periods for tariffs. However the preferences and expectations of more developed nations are contrary

to this. As a result, Japan would expect a different structure of agreement to what is found in South-South Agreements. For example, the product coverage in terms of tariff lines in BIMSTEC has been agreed at 80 percent, the same applies to the South Asian Free Trade Agreement. On the other hand, Japan's agreements with other countries have had far wider product coverage. For instance the Japan-Singapore EPA eliminates tariffs on over 98 percent of the total *value* of bilateral trade, the agreement with Malaysia covers 97 percent of total value of trade. The SAFTA on the other hand only covers 47 percent of total trade value (Weerakoon and Tennakoon, 2006). If Japan enters into an agreement with BIMSTEC it is likely that downward pressure will be imposed on the present exclusion of trade that has been agreed to. Whilst this will be beneficial to the overall interest of the agreement, it may well undermine the interests of the least developed members of BIMSTEC. It is possible that similar demands will be made of rules of origin and pace of liberalisation in order to meet the expectations of an advanced economy.

It could however be argued that North-South agreements provide significant benefits for developing nations, in the form of better access to markets where the multilateral system has failed, technology diffusion and binding liberal reforms. The reality has not quite matched up to these expectations. In terms of WTO plus issues, most North-South RTAs have resulted in the implementation WTO plus issues that are beneficial to developed partners, such as intellectual property and competition policy, being included whilst issues such as agricultural subsidies which are of interest to developing nations being excluded. For example, the recently signed economic partnership agreement (EPA) between Japan and Thailand is a comprehensive one which includes intellectual property rights, competition policy and government procurement as WTO plus issues. According to the agreement, the two countries have agreed to ensure protection of intellectual property, promote efficiency and transparency in the administration of intellectual property and take necessary measures to enforce such rights. In terms of government procurement, the countries have agreed to exchange information on their respective

laws and regulations, policies and practices on government procurement, as well as on any reforms to their existing government procurement regimes. According to the competition policy which the countries have agreed, both countries will promote fair and free competition within the respective economies. Sri Lanka's experience in Trade and Investment Framework Agreement (TIFA) with the USA suggests that trade agreements with developed countries involve WTO plus issues which are difficult to absorb by the developing countries. Under the Agreement, the USA requested Sri Lanka to amend intellectual property laws by removing legislation for compulsory licensing and parallel importation of drugs and pharmaceuticals and amend competition policy legislation by dropping the monopolies and mergers clause in order to grant duty free access in the USA for Sri Lankan ready made garments exports.

In terms of Japan's agreements with other partners, the few items that have been excluded from liberalisation have been those of major interest to developing nations: agriculture, leather, leather products, footwear under Japan-Singapore EPA (JSEPA); dairy products, pineapples, rice, rice products, wheat, meat and meat products, wood and wood products, fish and fish products, leather, leather products, and footwear under the Japan-Malaysia EPA (JMEPA); dairy products, apples, rice, rice products, wheat, plywood, bluefin tuna, leather, leather products, and footwear under the Japan-Mexico EPA (JUMSEPA). The wide ranging exclusions of agriculture and fisheries¹⁷ will make it difficult for countries like Sri Lanka to benefit to the fullest if Japan joins BIMSTEC. Whilst average tariffs are low in Japan, on certain products of interest to developing nations the tariffs are relatively high. This remains true even in Japan's trade agreements. While the overall simple average of GSP, JSEPA (Singapore), JUMSEPA (Mexico), and JMEPA (Malaysia) rates range from 3.3 percent to 5.3 percent; agriculture is subject to rates from 16.3 percent to 18.8 percent¹⁸. In these agreements tariffs are high on other products including leather, rubber, footwear and travel goods, and textiles and clothing imports. Furthermore certain items are not included in the GSP scheme, such as dairy products and some footwear and textiles and clothing.

This again suggests that a trade agreement with Japan has to generate higher market access in the products that are of export a of them in the interest to countries in the BIMSTEC.

5.5 Issues that Require Attention in BIMSTEC

Whilst there certainly are positives that can be gained by Sri Lanka and the rest of BIMSTEC if Japan were to join the regional grouping, there are several issues pertaining to the strength of BIMSTEC as a regional agreement that need to be addressed. These issues include the high transaction costs to trade in the region, the need for improved infrastructure, reduction of NTBs and the coverage of the agreement (negative lists). It would be premature to expect other countries like Japan to be interested in joining a regional grouping like BIMSTEC until such time the agreement is an effective means for increasing trade and economic integration in the region.

Box 1: Lessons from the ASEAN-Japan Comprehensive Economic Partnership (AJCEP)

ASEAN and Japan pledged to launch the ASEAN-Japan Comprehensive Economic Partnership (AJCEP) in late 2002 but it was not till November 2004, that they agreed to start negotiating a bilateral agreement. The talks formally started in April 2005, with a view to finishing up in two years (ie) March 2007, which has since been missed. Japan and ASEAN are expected to conclude negotiations before the end of this year. Japan is eager for a deal as soon as possible so it would not be left out, as ASEAN has already inked agreements with South Korea and China. For the Japanese government, this FTA has been an important target as it tries to achieve a stronger position in Asia vis-à-vis China and Korea. The finalisation of the US-Korea FTA talks in April 2007 has jolted Tokyo into high gear to get this deal completed, and the plan is now to wrap up negotiations by November 2007. This is the first time Tokyo has tried to hammer out a free-trade deal with an entire region. Both Japan and the ASEAN group have agreed to achieve full trade liberalization by 2012. What can be gathered from the negotiations between ASEAN and Japan which would be relevant for BIMSTEC if and when it would come to a point of dealing with Japan as a region in trade and investment are the following:

- Being a developed country, a trade agreement with Japan should

Box 1 continued

Box 1 continued

cover ‘substantially all trade’ in order to adhere to Article XXIV of the WTO. Therefore there cannot be a long exclusion list of sensitive items like in the current BIMSTEC agreement. In negotiating with ASEAN, Japan has made it known that in their understanding “substantially all trade” could mean at least 90 percent of the value of trade. In the case of the AJCEP, tariffs on 92 percent of total trade are expected to be fully cut and the rest to be removed gradually with the exemption of sensitive products.

- Whilst product coverage is likely to be higher than what is currently covered under the BIMSTEC framework agreement, some sensitive products of export importance interest of BIMSTEC countries could be excluded under a deal with JAPAN, namely some agricultural goods (rice) and fisheries products. Negotiations under AJCEP have made slow progress due to differences over tariff reductions for key items — agricultural produce for Japan and industrial products for ASEAN. It is expected that Japan will remove tariffs on almost all industrial products while either reducing or eliminating them on tropical fruit. Rice is expected to be excluded from the deal given the sensitivity of the product to Japan. On the other hand, Japan has requested for the liberalization of industrial products (ie) steel products and automobiles, which are of export interest to Japan. ASEAN was given a 10 year period to eliminate tariffs on steel products and automobiles. Liberalisation of these products will be of some concern for BIMSTEC countries including Sri Lanka which derives a substantial portion of government revenue for example from duties imposed on automobile imports.
- Rules of origin is still under negotiations in the AJEPA and it is likely to be complex and based on CTH criteria and product specific like in the case of Japan Singapore EPA (JSEPA) and Japan Malaysia EPA (JMEPA). For some products, it would be value addition rule of 40-60 percent while for some it would be the only criteria. In cases where there is an additional criteria, the domestic content requirement would be lower than 40-60 percent. AJCEP negotiations have been bogged down by differences on rules of origin between Japan and ASEAN, which favours less stringent and simple rules of origin. BIMSTEC is likely to face similar challenges in negotiating with Japan, which is strict on rules of origin criteria. This would not bode well for Sri Lanka given that it has always preferred a simple criterion in determination of rules of origin in its trade agreements.

Box 1 continued

- The AJCEP is more comprehensive than a free trade agreement, which focus largely on liberalization of trade in goods. The EPA covers not only trade in goods but services, investments, dispute settlement, sanitary and phyto-sanitary regulations, technical barriers to trade and on Japan's request, intellectual property rights. Thus, a deal with Japan would be comprehensive in coverage to include WTO-plus issues such as competition policy, intellectual property rights, etc amongst other issues, which should be a cause of concern for a number of BIMSTEC countries, including Sri Lanka. BIMSTEC countries would need to decide whether individual countries would be in a position to take up these issues at the regional level with Japan and whether the gains from trade would outweigh the loss in terms of policy space..
- Negotiating an agreement with Japan would not be easy and the process will be complicated given the fact that Japan already has an economic partnership agreement with Thailand and is negotiating one with India. The agreement with Thailand (JTEPA) was signed in April 2007 but is yet to be implemented by either side. At the moment discussions with India is at very early stages with launch of talks in December 2006 but both countries have pledged to conclude the talks within two years (early 2009). Thus, a proposed agreement between the BIMSTEC and Japan is likely to face the same sort of challenges as ASEAN is currently experiencing in negotiating a deal with Japan, which has preferred to take the bilateral approach. Japan has already inked bilateral EPAs with a number of ASEAN countries. Currently Japan has agreements with Malaysia, Singapore, Thailand and the Philippines and is negotiating more deals with other countries in the region (Indonesia, Vietnam and Brunei) while the region as a whole is in talks with Japan. This has complicated the negotiations of Japan-ASEAN Comprehensive Economic Partnership (JACEP) in terms of how to integrate bilateral agreements with their different modalities and schedules into a regional wide agreement involving Japan.
- Last but not least, it is important to recognize that ASEAN as a region is an important trading partner of Japan and ASEAN-Japan relations has a long history with contacts established as way back as 1973, which has made significant progress since then with broadening and deepening of cooperation to cover political and security, economic and financial, and social and cultural areas. In this regard, BIMSTEC is a relatively young organization, which needs to establish such relations with Japan.

Source: ASEAN Secretariat, Jakarta.

Transaction costs in BIMSTEC are high, particularly in the South Asian members of the region. These transaction costs include excessive documentation¹⁹, high service charges at ports, transport costs due to weak infrastructure and non-cooperation at borders, time wastage at customs due to non-cooperation, lack of harmonization and unpredictability. These high transaction costs deter trade in the region and undermine the pursuit of business opportunities. Improved transport infrastructure is a key to reducing transaction costs in the region. Road and rail networks within South Asia and within individual countries are poor. Terrains in Nepal and Bhutan make them difficult to access as well. There is also a strong case for increased cooperation in transport infrastructure projects where the benefits are felt by more than one country (e.g. Trans-national highways.) There are also many trade facilitation measures that could be undertaken to improve the movement of goods in the region. Simplification and harmonisation of customs procedures is very important since at present many of the less developed BIMSTEC members continue to rely on manual customs clearance, resulting in delays and wastage, particularly of perishable goods. The need for standards harmonisation has already been mentioned. This applies to trade in services as well, particularly for mutual recognition agreements in professional services. It would be worthwhile identifying the most heavily traded items in BIMSTEC which are adversely affected by divergences in standards, and prioritising the harmonisation of these to start with.

Non-tariff barriers are relatively high in BIMSTEC, both for reasons of protection and due to various avoidable factors increasing the transactions costs to trade. In India for instance there remains tariff rate quotas (TRQs) on 14 tariff lines²⁰ (HS 8-digit level), import restrictions and licensing, limits on port availability, SPS measures which as some WTO members have claimed, deviate from international standards. In Sri Lanka there are bans on imports of tea and certain spices due to fears of lower grade imports being blended with Sri Lankan products, undermining their quality and competitiveness on international markets. Bangladesh maintains several para-tariffs (industrial development surcharge and

supplementary duties), to the extent that 38 percent of the average protection is due to para-tariffs. Bangladesh also imposes quantitative restrictions on eggs, poultry and salt for which the government obtained waivers from the WTO²¹. As tariffs fall through trade liberalisation at unilateral, regional and multilateral levels, the importance of NTBs as protective devices will continue to grow. In this context it is important that BIMSTEC takes steps to eliminate existing, protectionist NTBs in the region and have a transparent and predictable means of identifying and removing any NTBs that emerge in the future. If NTBs are not appropriately addressed the impact of the FTA will be greatly undermined.

The size of negative lists is another area of concern in BIMSTEC. As it stands 20 percent of tariff lines can be placed in the negative list. In SAFTA the same approach was adopted, and the result was very high levels of trade exclusion. This was particularly true of the LDCs which placed between 64 percent and 74 percent of their total import values from South Asia under NL protection. All in all almost 53 percent of total imports in South Asia are subject to negative lists; 47 percent of Sri Lankan exports, 57 percent of Indian and Maldivian exports are restricted by the NLs of fellow SAARC members, allowing little scope for improved market access through SAFTA²². BIMSTEC should have a mechanism whereby the size of the negative list is phased out in a consistent, predictable manner like in ASEAN. Until these issues are addressed, it is unlikely that BIMSTEC will be the dynamic regional grouping that its members hope it would be. Only then would there be a realistic chance of other countries being interested in entering the fold as full members.

6. Conclusions

BIMSTEC is one of many regional trade agreements that Sri Lanka has signed up to. At present the potential for benefits from the agreement are limited to increased access to markets of Thailand and Myanmar since Sri Lanka already has access to India and Bangladesh, Bhutan, Nepal through ILFTA and SAFTA respectively. In this context, the addition of a new country, Japan to BIMSTEC would increase the potential benefits to Sri Lanka.

It should also be noted that a lot of work needs to be done to get BIMSTEC's own house in order before countries like Japan would even be interested in getting involved in such an agreement. Low trade coverage, high transactions costs to trade and existing FTAs (Japan's economic agreement with Thailand and pending agreement with India are likely to reduce Japan's interest in entering into an agreement with BIMSTEC region) are cases in point. Japan could however play an important role in boosting economic cooperation in BIMSTEC if it were to join. For instance, building transport infrastructure will be crucial to promote regional cooperation and in this regard Japanese ODA can play a significant role. Furthermore, the entry of Japan would boost competition in the region and act as a catalyst for upgrading quality and standards of production and service supply in the region. These potential dynamic benefits will make it worthwhile giving strong consideration to Japan's entry into BIMSTEC whilst being aware of the challenges that have been outlined in this paper.

Endnotes

- ¹ Japan has agreements with Singapore (2002), Mexico (2005), the Philippines (2004), Malaysia (2005) and Thailand (2005), and it is currently negotiating with South Korea, ASEAN, Indonesia, Chile and is moving toward talks with Australia, India, Switzerland, Vietnam and South Africa. Tokyo also plans to open negotiations with Gulf Cooperation Council (GCC) members-Saudi Arabia, Bahrain, Kuwait, Oman, Qatar and the United Arab Emirates. The deals put forward by Japan are called Economic Partnership Agreements as the Japanese government holds the view that the term free trade agreement does not capture the broader integration of economic and social policies these agreements aim to achieve. But these EPAs are similar in coverage to a typical Northern FTAs.
- ² This would include strengthening cooperation in the already identified sectors (technology, transportation and communication, energy, tourism and fisheries), enhance trade facilitation, and implement capacity building and technical assistance particularly to LDCs.
- ³ For the purpose of conducting negotiations in specific areas, the TNC established the formal Working Group on Rules of Origin (ROO), Working Group on Dispute Settlement Mechanism (DSM), Working Group on Customs Cooperation, and the informal Working Group on Safeguards and Draft Text on the Agreement on Trade in Goods. Working Group Meetings on Investments and Services have also been held.
- ⁴ Thailand has expressed an interest in joining the Bangkok Agreement in the past.

- ⁵ Exports to Myanmar may be expected to improve after the formation of the Joint Commission between Sri Lanka and Myanmar, the first meeting of which was held on July 10-11 2007. At the meeting, the Sri Lankan delegation obtained assurances that difficulties facing exporters would be addressed expeditiously. http://www.news.lk/index.php?option=com_content&task=view&id=2890&Itemid=44
- ⁶ Further, 32 Indian projects valued at Rs. 11,847.1mn have been invested under the Normal Laws of the country as of 2006.
- ⁷ CBSL Annual Report 2006
- ⁸ There are also a number of small-scale enterprises with Japanese investment operating under the normal laws of the country that are engaged in the services sector (restaurants, apparel, tourism and travel, and export trading).
- ⁹ In terms of numbers, it has been in manufacturing (70 percent), most of which is low in technology and labour intensive in production.
- ¹⁰ Japanese Embassy website
- ¹¹ Trade potential is defined as the lower of the value a selected country exports to the world or the value the partner country imports from the world minus the current trade between the two countries. Thus value is a theoretical maximal trade between the two partner countries (TradeMap website)
- ¹² The gravity model was used in many studies in the 90s to predict the impact of tariff reductions on bilateral trade flows between countries because of its empirical success, improved theoretical foundations (derived from modern theories of trade in imperfect substitutes) and new connections between geography and trade.
- ¹³ India had the highest rate of customs tariff of 28 percent while the lowest tariff rate of 2.8 percent was recorded in the case of Japan. Bhutan was not included in most of the analysis due to lack of tariff data.
- ¹⁴ Although useful, gravity model study has several drawbacks that must be borne in mind when examining the results. For example, the model does not take into account the effect of the terms of trade associated with trade creation. Hence, the simulated results are upward biased. Furthermore, the analysis is carried out in a static framework – which underestimates the extent of intraregional trade. In a dynamic framework there may be factors such as changes in terms of trade, technology spillover, achievement of economies of scale, etc. that will enhance the impact. It is also quite difficult to quantify some of the parameters e.g. there is no information on scale economies. There is no consideration of restrictions due to non-tariff barriers. The negative effect on bilateral trade with countries not part of the hypothetical RTA has also not been assessed. Lastly, the gains mentioned are only gains in terms of trade and not specifically related to welfare.
- ¹⁵ The Japan Industrial Standards (JIS) mark is a voluntary standard covering all industrial products except those regulated by specific laws. About 93 percent of JIS (92 percent in 2004) were aligned to their international counterparts in 2005. The Japan Agricultural Standard (JAS) is the agriculture equivalent to the JIS. Besides these standards there is also a product liability law, making manufacturers liable for compensation.

- ¹⁶ For instance laws relating to privacy, data protection, liability and consumer protection have had an adverse impact on outsourcing.
- ¹⁷ Even in services it is unlikely that significant concessions will be made in Mode 4.
- ¹⁸ Japan WTO Trade Policy Review 2007.
- ¹⁹ It was estimated that Indian exporters need to obtain 258 signatures and 118 copies of the required documents such as registration with income and sales tax, bills of entry, export and shipping bills, licences for importing negative listed goods, inspection certificates for 2nd hand goods and pre-shipment inspection certificates.
- ²⁰ Though not all of these are filled.
- ²¹ World Bank www.worldbank.org
- ²² Weerakoon and Tennekoon, Economic and Political Weekly, September 2006.

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