

Economic Growth in Sri Lanka: Trade with SAARC or Trade with ASEAN

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Introduction

Trade is generally identified as a key engine of economic growth and welfare. Therefore, countries around the world continuously attempt to develop trade relationships with each other. Sri Lanka has signed many of its trade agreements with other SAARC (South Asian Association for Regional Cooperation) countries. In addition to the South Asian Free Trade Agreement (SAFTA) and bilateral trade agreements with India and Pakistan, another FTA is expected to be signed with Bangladesh. Apart from its continuing interest in trading with SAARC countries, Sri Lanka is also exploring possibilities for trade beyond SAARC. In fact, the country is currently more interested in developing its bilateral trade relationships with ASEAN (Association of the Southeast Asian Nations) countries. Sri Lanka's first ever FTA with an ASEAN member was signed in January 2018, with Singapore. It is also planning to sign trade agreements with three other ASEAN countries which are Indonesia, Malaysia and Thailand. Hence, this paper aims to analyse whether it is trade with SAARC or trade with ASEAN which can promote economic growth in Sri Lanka.

Few studies have focused on the impact of trade with SAARC and ASEAN on economic growth in Sri Lanka. Almost all of those studies are descriptive and there is hardly any empirical study conducted on the particular issue. Most of the researchers recommend that under the current economic and political circumstances, trading with other countries is better for economic growth in Sri Lanka than trading with SAARC members. Bandara and Yu

(2001) find that unilateral liberalisation would benefit South Asian countries much more than preferential liberalisation. Weerakoon and Wijayasiri (2001) show that the technology, investment and trade needs of Sri Lanka are more closely aligned to those of its East Asian neighbours than to Bangladesh, Bhutan, Nepal or the Maldives. Ali and Talukder (2009) find that, with an insignificant share in world trade and persistent high levels of tariff barriers, the gains from free trade arrangements in the South Asian region are likely to be minimal. They highlight the possibility that small countries may lose and large countries may gain from an FTA in such a region. However, they emphasize the importance of exposure to a regional market for an economy in order to expand market size, gain economies of scale and increase the competitiveness of domestic firms.

Certain studies have emphasized that developing trade relationships with India is important for Sri Lanka to gain access to Southeast Asia. Weerakoon and Perera (2014) show that Sri Lanka can benefit from greater connectivity with South and Southeast Asia by pursuing closer economic integration with its neighbours. They argue that Sri Lanka should expand the current bilateral free trade agreement with India because many of the country's competitors in the Asian region have gained access to markets through such beneficial deals. Bhattacharyay (2014) also shows that integrating India - and through India other major South Asian economies such as Bangladesh, Pakistan, and Sri Lanka - to the South East Asian production network will create win-win situations for both regions. Through this, it is expected to reduce the excessive dependence of South Asia on advanced countries in the West. However, this leads to a new question whether the small countries in South Asia will then start to depend on India.

Objectives

Accordingly, the two objectives of this study are to analyse the growth contribution of SAARC-Sri Lanka trade and ASEAN-Sri Lanka trade, and thereby draw policy implications of the findings.

Methodology

There is hardly any empirical study on the growth contribution of trade with SAARC and ASEAN for Sri Lanka. Therefore, this study has attempted to provide a foundation to conduct an empirical analysis on the particular issue.

This study conducted a time series analysis on the impact of trade with SAARC and ASEAN on economic growth in Sri Lanka, during 1990-2016. In constructing the model, the Neo-classical growth accounting equation was used, which explains what part of growth in total output is due to growth in different factors of production. Neo-classical growth theory shows that the output of an economy is determined by three factors, which are capital, labour and technology. Considering trade as another determinant of economic growth, the following regression model was constructed.

$$\text{LNGDP}_t = \beta_0 + \beta_1 \text{LNGCF}_t + \beta_2 \text{LFPR}_t + \beta_3 \text{SAARC}_t + \beta_4 \text{ASEAN}_t + \varepsilon_t \quad (1)$$

where LNGDP is the log of real GDP, LNGCF is the log of real gross capital formation, LFPR is the labour force participation rate, SAARC is the log of total trade with SAARC (due to the lack of data, Bhutan and Nepal were excluded), ASEAN is the log of total trade with ASEAN (due to the lack of data, Brunei, Cambodia and Laos were excluded), ε is the error term and the subscript t indicates time. All the variables are relevant to Sri Lanka and secondary data were collected from two online databases which are World Development Indicators⁷ and ARIC Integration Indicators⁸.

Augmented Dickey Fuller and Philips Perron unit root tests were used to check whether the variables are stationary. Schwarz criterion was used as the model selection criterion. Auto Regressive Distributed Lag (ARDL) Bounds Testing approach was used to study the long run equilibrium relationship between variables. ARDL Error Correction Model was estimated to study the short run relationship between variables. The level of significance considered in the analysis is 5 percent. Diagnostic Tests were conducted to check whether the results are robust. The tests conducted are, Jarque-Bera test to

⁷Available at: <http://databank.worldbank.org/data/reports.aspx?source=world-development-indicators>

⁸Available at: <https://aric.adb.org/integrationindicators>

check whether the residuals are normally distributed, Lagrange Multiplier (LM) test to detect serial correlation among residuals, Breusch-Pagan-Godfrey test to detect heteroscedasticity in the model, Ramsey RESET test to check whether the model is specified correctly. Cumulative Sum (CUSUM) test and Cumulative Sum Squares (CUSUMSQ) test to check the stability of the model.

Results and Discussion

After confirming that there is cointegration among variables in the model through the ARDL bounds test, ARDL long run and short run estimations were derived. Accordingly, trade with SAARC as well as with ASEAN has a positive and significant impact on the GDP of Sri Lanka in the long run. When trade with SAARC increases by 1 percent, the GDP of Sri Lanka increases by 13.6 percent, *ceteris paribus*. When trade with ASEAN increases by 1 percent, the GDP of Sri Lanka increases by 8.9 percent, *ceteris paribus*. However, in the short run, trade with SAARC has a negative impact on Sri Lanka's GDP. When trade with SAARC increases by 1 percent, GDP decreases by 2.3 percent in the short run, *ceteris paribus*. In the short run, trade with ASEAN has a positive impact on Sri Lanka's GDP only at 10 percent level of significance. Gross capital formation has a positive and significant impact on the GDP of Sri Lanka both in the long run and short run. However, labour force participation rate has no impact on the GDP of Sri Lanka either in the long run or short run. The Error Correction Term which is negative and significant shows that the model is stable in the long run and there is long run causality. GDP growth moves back to the equilibrium path and the disequilibrium error is corrected by 38% each year following an exogenous shock. All the diagnostic tests proved that there are no diagnostic errors in the model and that the results are robust.

According to the findings, trading with both SAARC and ASEAN promotes economic growth in Sri Lanka in the long run. It should be noted that in 2016, SAARC accounted for 10 percent of Sri Lanka's exports and 22 percent of the country's imports.⁹ ASEAN accounted for only 3 percent of Sri Lanka's exports and 15 percent of the country's imports. However, Sri Lanka's trade with SAARC is mainly dominated by India. In 2016, India

⁹ Source: ITC Trade Map. Available at: <https://www.trademap.org>

accounted for around 72 percent of Sri Lanka's exports to SAARC and 90 percent of its imports from SAARC. In fact, India is Sri Lanka's largest origin of imports after China. But Sri Lanka imports from Singapore, Malaysia, Thailand and Indonesia more than from any SAARC country except for India. Further, Bangladesh, Maldives and Singapore each accounts for around 1 percent of Sri Lanka's exports. Thus, India should have played a significant role behind the impact of trade with SAARC on economic growth in Sri Lanka. Among ASEAN countries, Singapore has the largest effect on Sri Lanka's trade.

Conclusion

This study followed Neoclassical growth theory in a time series analysis conducted to address the problem, 'which is better for economic growth in Sri Lanka, trade with SAARC or trade with ASEAN?', considering the period from 1990 to 2016. The main objectives of the study were to analyse the growth contribution of SAARC-Sri Lanka trade and ASEAN-Sri Lanka trade, and thereby draw policy implications of the findings. The results showed that both ways of trading promote economic growth in Sri Lanka in the long run. Therefore, Sri Lanka should expand its trade with countries in both regions in order to reap growth benefits in the long run. In fact, the country should improve its trade relationships with India and Singapore.

It is likely that trading with SAARC promotes economic growth in Sri Lanka, especially because of free trade agreements with India and Pakistan. However, although with no trade agreements signed during the period considered, trade with ASEAN has also contributed significantly to economic growth in Sri Lanka. Given that ASEAN is a region with some high income economies with a considerable population and exporting high technology products, this region can have more growth potential than SAARC. Therefore, it can be concluded that Sri Lanka's FTAs with ASEAN countries can be beneficial for the future economic growth in the country. However, policy makers should make sure that the prospective agreements are designed so as to give the maximum possible benefit to Sri Lanka.

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