



Graduate School of Development Studies

**‘Geostrategic Neoliberalism’ and India’s New  
Neighbourhood Policy:  
Examining the Geopolitical Drivers of the Indo-Lanka  
Free Trade Agreement**

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## List of Acronyms

BJP – *Bharatiya Janata Party*  
CEPA – Comprehensive Economic Partnership Agreement  
FTA – Free Trade Agreement  
GATS – General Agreement on Trade in Services  
IFIs – International Financial Institutions  
ILA – India-Sri Lanka Bilateral Free Trade Agreement  
IPE – International Political Economy  
JVP – *Janata Vimukti Peramuna*  
LDC – Least Developed Country  
LTTE – Liberation Tigers of Tamil Eelam  
NFF – National Freedom Front  
NTB – Non-tariff barrier  
PA – People’s Alliance  
PTA – Preferential Trading Arrangement  
ROO – Rules of origin  
RTA – Regional Trade Arrangement  
SAARC – South Asian Association for Regional Cooperation  
SAARC-LDC – Least Developed Country within SAARC  
SAFTA – South Asian Free Trade Area  
SAPTA – South Asian Preferential Trading Arrangement  
SDT – Special and differential treatment  
SLFP – Sri Lanka Freedom Party  
TRQ – Tariff rate quota  
UNP – United National Party  
WTO – World Trade Organisation

## Glossary

Gujral doctrine – Is a set of five principles used to guide the conduct of foreign relations with India's immediate neighbours as spelt out by I.K. Gujral, first as India's foreign minister and later as the prime minister. The five principles are: (i) India does not ask for reciprocity from its neighbours, but gives and accommodates what it can in good faith and trust; (ii) no South Asian country should allow its territory to be used against the interest of another country of the region; (iii) no country should interfere in the internal affairs of another; (iv) all South Asian countries must respect each other's territorial integrity and sovereignty; and, (v) all South Asian countries should settle all their disputes through peaceful bilateral negotiations (Murty 1999).

Hindu – A religious category. The majority, comprising 80.5 percent of the population in India are Hindu, while 13.4 percent are Muslim.

LTTE – The Liberation Tigers of Tamil Eelam, also known as the 'Tamil Tigers', are a secessionist Tamil militant group in Sri Lanka. The LTTE has, since the late-1970s been waging an armed conflict against the Sri Lankan state in the north and east of the country, to carve out a separate state for the country's minority Tamil community. While almost all members of the LTTE are Tamil, not all Tamils support the LTTE.

Positive spillovers – The term is used when some of the economic benefits of trade and investment accrue to economic agents other than the party that undertakes the transaction.

SAARC-LDCs and SAARC-non-LDCs – Within SAARC, Bangladesh, Bhutan, Nepal, the Maldives and Afghanistan are categorised as LDCs or Least Developed Countries, while India, Pakistan and Sri Lanka are categorised as non-LDCs. This categorisation is based on the criteria for LDCs set by the Economic and Social Council of the UN.

Sinhala – An ethnic category denoting the majority community living in Sri Lanka. The Sinhala community comprises 73.8 percent of the population of Sri Lanka.

Tamil – An ethnic category denoting one of the minority communities living in Sri Lanka. Tamils comprise 18.5 percent of the population in Sri Lanka. The Tamil community in Sri Lanka can be further subdivided into those of Sri Lankan and of Indian origin.

Tamil Eelam – The name of the separate Tamil state which the LTTE is seeking to carve out of Sri Lanka through an armed conflict.

Vanaspati – A hydrogenated vegetable oil similar to *ghee*. Vanaspati oil is refined from palm oil inputs imported from East Asia to Sri Lanka under duty free conditions.



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## **Abstract**

This research paper examines the geopolitical drivers of the Indo-Lanka Free Trade Agreement (ILA) from a realist IPE perspective. The study concludes that in addition to economic imperatives, there are compelling geopolitical factors driving the ILA, in the context of the transformation of India's neighbourhood policy following economic liberalisation in 1991. It argues that India's new neighbourhood policy of 'geostrategic neoliberalism', which incorporates neoliberal ideology driven by geopolitical imperatives, is a compelling driver of the ILA. It is driven by India's desire to seek prosperity and stability in the neighbourhood, through economic engagement, in order to achieve its ambition of emerging as a credible global power. It is complemented by the mutual desire of India and Sri Lanka to enhance their respective geostrategic space through economic integration. The ILA, which incorporates the principle of asymmetric responsibility and grants special concessions to Sri Lanka, becomes a neoliberal instrument used in this new economic engagement. The neoliberal project has recast India's role as regional hegemon in a more accommodative light than during its pre-liberalisation phase, marking its transformation from threat to opportunity. But it also incorporates a version of Indian hegemony that is more expansive than earlier. This transformation is leading to a trend of India-centric convergence of all countries in South Asia, except Pakistan. Sri Lanka stands to benefit both politically and economically from this evolving relationship.

## **Relevance to Development Studies**

Many studies on neoliberalism see it as a largely technocratic project. My research paper shows that neoliberal projects are driven by strong political imperatives. It highlights the interaction of economics, geopolitics and security in neoliberal ideology. It looks at the impact of neoliberalism on a south-south FTA, and how it is transforming a bilateral relationship between two developing countries with asymmetric power relations and reorganising their respective economic space. It shows how the dynamism of the FTA has strong geopolitical interests that are often implicit, and embedded within a seemingly economic process. This research has also enabled me to examine the linkages between development studies and foreign policy by highlighting the impact of neoliberalism on the transformation of foreign policy.

## **Keywords**

ILA / CEPA / geostrategic neoliberalism / India / Sri Lanka / realist/  
geopolitical / neighbourhood policy

# Chapter 1

## INTRODUCTION

### 1.1 Introduction

This paper examines geopolitical drivers of the India-Sri Lanka Bilateral Free Trade Agreement, hereafter known as the ILA. The latter was signed between the governments of India and Sri Lanka in December 1998 and implemented in March 2000. It was the first bilateral Free Trade Agreement in the South Asian region, and a south-south Agreement. At the time of signing, bilateral trade between the two countries was modest. However, following its implementation, there was an immediate and dramatic increase in two-way trade, a surge in the volume of exports to Sri Lanka, and a shift in its export composition, from agricultural to manufactured goods. By 2005, 97 percent of Sri Lanka's exports were entering India duty-free (Wickramasinghe 2007: 13). The ILA also led to an increase in Indian investment into Sri Lanka, with India moving from 16<sup>th</sup> largest importer at the time of signing, to the island's top investor in 2002/2003. Today, over 50 percent of Indian investment in the South Asian region is in Sri Lanka. India's trade with Sri Lanka also increased overwhelmingly, but it cannot be solely attributed to the ILA.

The increase in trade and investment co-occurred with unilateral liberalisation policies launched independently in both countries that resulted in positive spillovers in Sri Lanka's services and investment sectors, and generated greater connectivity between the two countries (Kelegama and Mukherji 2007: 20). Indian services in health, air travel, hotels/restaurants, retailing and distribution sectors invested in Sri Lanka. Sri Lankan services such as shipbuilding/repairs, freight forwarding also flourished. Its national carrier, SriLankan airlines, established itself as a regional hub, and is today the largest single foreign carrier to India, with 42 percent of the airlines' revenue emanating from Indian operations (Kelegama and Mukherji 2007: 20). In terms of sea connectivity, the Colombo port emerged as a regional hub. Liberalisation of the aviation sector in both countries, combined with Sri Lanka's unilateral implementation of visa-on-arrival policy for Indian nationals in 2002, led to India becoming one of the top three markets for tourist arrivals to Sri Lanka from 2003. The combined effect of the ILA and unilateral economic measures of both countries gave synergic effect to it, stimulating the two governments to upgrade it to a Comprehensive Economic Partnership Agreement (CEPA) covering trade in services and investment. Discussions/negotiations on this progressed from 2002 to 2008.

Despite many criticisms, most studies on the ILA acknowledge its dynamism (Weerakoon and Thennakoon 2008: 139; Kelegama and Mukherji 2007: 5; Wickramasinghe 2007: 31-32; JSG Report 2003: iii-v). Baysan et al. (2006: 4-7) call it the 'the most effective FTA in existence in the region'. I

define its dynamism in terms of the market access it has brought to the smaller economy of Sri Lanka. The increase in two-way trade and investment, the change in Sri Lanka's export composition, the positive spillovers on Sri Lanka's services and investment sectors, the increase in connectivity, are taken as indicators of its dynamism. I do not define dynamism in terms of whether the ILA has been effective or not, or whether it has led to trade creation or trade diversion (for an overview of the ILA's impact see Annex 2).

This dynamism of the ILA gains prominence against the stagnation of the regional preferential trading arrangement of SAPTA/SAFTA. I call the latter the multilateral track, while I see the ILA as the bilateral track. The South Asian Association for Regional Cooperation (SAARC) encompasses eight countries – India, Bangladesh, Pakistan, Sri Lanka, Nepal, Bhutan, the Maldives and its latest entrant, Afghanistan. Economic cooperation entered the SAARC agenda a decade after its inception, with the launching of the SAPTA in 1995 which, irrespective of its failure, was upgraded to SAFTA in 2004. Despite the continuity of SAARC, South Asia remains one of the least integrated regions in the world, both economically and politically.

The stagnation of the multilateral track co-incided with a proliferation of bilateral preferential trade agreements (PTAs) in South Asia from the late-1990s. They include the non-reciprocal bilateral trade agreements that India has signed with landlocked Nepal and Bhutan, the Indo-Afghanistan PTA, and the Pakistan-Sri Lanka FTA (2005). The shifting dynamics between bilateralism and multilateralism in South Asia is examined vis-à-vis the ILA.

## **1.2 Research Problem and Hypothesis**

The central research questions this paper seeks to address are the following:

- How should the dynamism of the ILA be conceptualised? and
- What are the geopolitical drivers of the ILA?

Emanating from the above, my research sub-questions are:

- What are Sri Lanka's motivations?
- What are India's motivations?

The first issue that comes to mind when studying the ILA is the vast asymmetries between India and Sri Lanka in terms of size, demography and economy. India accounts for almost 78% of total area, 75% of total population and 80% of GDP of South Asia. It is also the second largest country in Asia. Sri Lanka with its total area of 65,610 sq.km. and population of 21 million, is smaller than some local states in India. The vast asymmetries make one wonder what motivated India and Sri Lanka to enter into the ILA.

Several contemporary studies examine the dynamism of the ILA, mainly from an economic perspective. They show a compelling economic motivation for Sri Lanka to enter into it: the desire for deeper integration in the world economy via India. But they fail to adequately explain India's motivations in entering into the ILA.

From an Indian perspective, Sri Lanka is a very small market. It owns only 2 percent of SAARC regional GDP. Even after the ILA, it only accounts for around 2 percent of total Indian exports and less than 1 percent of its imports. India's total investment in Sri Lanka in 2007 was still less than 1 percent of its total investment overseas (Kelegama and Mukherji 2007: 18). The primary benefit to India does not therefore appear to be economic, though it may well be economic for Sri Lanka. India's economic interests today clearly lie elsewhere. It seeks deeper economic integration via partnership agreements with East and Southeast Asia, the EU and the US.

These studies also fail to capture the dynamics of Indo-Lanka bilateral relations in the broader context. Within the region, India's interests appear to be more geostrategic than economic, given the intra-regional security threats. They are linked to India's role as a regional power and an emerging global power. The ILA was preceded by a gradual liberalisation of India's economy from 1991. But with the economic reform process, and the ascendance of neoliberal ideology, its neighbourhood policy has also undergone a subtle transformation. India's coercive relations with Sri Lanka, which prevailed in the 1980s, have been replaced by increasing economic engagement in the 1990s, which led to more cooperative bilateral relations. I examine the ILA's dynamism in the context of this transformation in India's neighbourhood policy. But this transformation is complicated by the continued prioritisation of geopolitical imperatives within India's neighbourhood and in the world at large.

My hypothesis is that in addition to economic imperatives, there may be compelling geopolitical imperatives driving the ILA, in the context of the transformation of India's neighbourhood policy towards Sri Lanka in its post-liberalisation (post-1991) phase.

### **1.3 Significance of the Study**

There are several economic studies available on the ILA (De Mel 2008; Kelegama 2008, 2007, 2006a, 2003; Weerakoon and Thennakoon 2008; Tudugala 2008; Kelegama and Mukherji 2007; Wickramasinghe 2007; Abeyasinghe 2007; Baysan et al. 2006; Weerakoon 2001; Weerakoon and Wijayasiri 2001; Pitigala 2005). There is, however, no study that has examined its geopolitical imperatives from a political economy perspective. While there exists an abundance of foreign policy studies on South Asia and on Indo-Lanka relations, there is a paucity of literature on foreign policy imperatives of

the ILA and its impact on Indo-Lanka relations. My research paper hopes to address these gaps.

#### **1.4 Scope and Limitations**

Indo-Lanka engagement via the ILA is part of a larger pattern replicated by an emerging India in the neighbourhood, as well as globally. It has to be acknowledged therefore that it reflects just one aspect of India's relations with Sri Lanka which, in its post-1991 phase, incorporate many other dimensions of bilateral cooperation such as aid, technical cooperation, etc. I have not undertaken a study of these issues as it is beyond the scope of this research. I have strictly limited foreign policy parameters of the paper to India's neighbourhood policy and, within that, to its policy towards Sri Lanka. Only comparative reference is made to India's policy towards other countries in the neighbourhood, as and when it is deemed necessary. I have also not compared the ILA to other bilateral trading arrangements in the neighbourhood.

I argue that the ILA is leading to greater connectivity and the deepening of bilateral engagement between India and Sri Lanka, but I have not measured the effectiveness of the ILA in economic terms as it is not the objective of this paper. I have not undertaken a comprehensive study of SAPTA/SAFTA or the SAARC process, and only comparative reference is made to them.

Finally, while I have had extensive access to the Sri Lankan side in collecting data, I have had only limited access to the Indian side. In addition to information provided by some Indian sources, a certain portion of India's geostrategic thinking is reconstructed through interviews conducted with Sri Lankan sources, and through secondary data.

#### **1.5 Research Methodology**

I have undertaken an exploratory research in this paper. I have used as my research techniques the conduct of semi-structured interviews to gather primary data, and the use of secondary data, to obtain qualitative information on the subject. Semi-structured interviews were conducted with senior policymakers and policy implementers of the Sri Lankan and Indian governments; as well as academics/scholars and the business community of the two countries (see Annex 1). Most interviews and data gathering were conducted in Sri Lanka. Some interviews with sources based outside Sri Lanka/the Netherlands, were conducted via telephone. Secondary data used in the research include literature on the ILA/CEPA/SAFTA/SAARC; India/Sri Lanka/South Asia and Indo-Lanka relations; Indian and Sri Lankan government policy documents/briefs; political economy and neoliberalism; and other publications. The combination of semi-structured interviews with secondary data has helped triangulate my analysis. Semi-structured interviews

added flexibility to my research and enabled me to ask the same question in different ways. Due to the sensitive nature of the subject, I have maintained the anonymity of my sources in certain instances. As a result, in some sections in Chapters 4 and 5, I have not given the name of my source, but referred to him/her as ‘a Sri Lankan technocrat’/‘an Indian diplomat’, etc.

## **1.6 Structure of the Research Paper**

Chapter 2 provides the conceptual framework of the research paper. Chapter 3 provides a review of existing scholarship that has examined the drivers of the ILA under the broad categories of economic and political. Chapter 4 provides a political economy analysis of the ILA/CEPA process. Chapter 5 places the ILA in the broader context of India’s neighbourhood policy and its transformation in the post-1991 period. Chapter 6 sums up the main arguments.

## **Chapter 2**

### **CONCEPTUAL FRAMEWORK**

#### **2.1 Introduction**

The objective of my research is to examine the geopolitical imperatives of the ILA. My hypothesis is that in addition to economic imperatives, compelling geopolitical imperatives are driving it, in the context of the transformation of India's neighbourhood policy towards Sri Lanka, since it liberalised its economy. To illustrate this process, I examine political economy drivers of the ILA in the context of Indo-Lanka bilateral relations. I trace the gradual transformation of India's neighbourhood policy from a realist orientation in the 1970s/1980s to a more accommodative power, in the post-1991 period.

#### **2.2 Conceptual Framework**

##### ***2.2.1 An International Political Economy Approach***

I adopt an international political economy (IPE) approach as the main analytical tool in my research. It examines the politics of economic relations on a national, regional and global scale. It shows that economics is not an abstract science but embedded in politics and a site for power contestation by different interest groups. In examining the politics of trade, IPE places great emphasis on institutions in forging economic engagement, and on the history of a given process. From an IPE perspective, the ILA can be posited as a political economy instrument/institution that is transforming the bilateral relationship between India and Sri Lanka. Such a perspective enables me to examine the ILA in historical context, from the perspectives of India and Sri Lanka with their different and convergent interests, including foreign policy.

##### ***2.2.2 The Realist Tradition***

A primary focus of my research is the bilateral relationship between India and Sri Lanka and their foreign policy linkages. In analysing this I adopt a state-centric, realist approach to IPE, which is a theoretical framework developed by Gilpin (2001: 3-24). The realist tradition is based upon three assumptions (Gilpin 1986: 304-305). The first is the conflictual and anarchic nature of international affairs. The second is the essence of social reality being based on the group and not the individual. In Gilpin's case this group is the nation-state which is the building block of the current international order. The third is primacy in all political life being given to power and security. Additionally, realism posits an intimate connection between international politics and international economics (Gilpin 1986: 308-309).



The realist tradition gives primacy to the nation-state, and conceives its strengthening, even when globalisation and resulting economic convergence are bringing about increasing interdependence between states. Like IPE, realism conceives economics as determined by politics. Gilpin (2001: 3-24) projects the functioning of the world economy as determined by both markets and the policies of nation-states. The latter are seen to be central to creating and sustaining markets, and to be the driving force behind global economic integration which, in turn, is seen to be driven by their economic and political objectives and national interests. Gilpin (2001: 3-24) establishes a strong relationship between economic power and security, and sees security concerns taking primacy over trade.

Power in the international system is understood by Gilpin (2001: 3-24) as configured in nation-states. In the realist tradition, nation-states compete for power in a world of scarce resources (Gilpin 1986: 304-305). But as nation-states are not monolithic entities, they themselves become sites of contestation for a complex web of power relations, within different groups constituting each state. These power relations can be both coercive and cooperative. The very structure of Indo-Lanka relations is embedded in a complex power differential between a large regional power (India), and a small, weak state (Sri Lanka). India's neoliberal project is, at one level, a site of contestation and negotiation for power between the different advocates of the state and the market.

Reference is made in my research paper to 'India' and 'Sri Lanka' and their respective 'national interests'. This is matter of convenience and economy, and not an acknowledgement that they exist as monolithic social/political entities. I see these terms as denoting nation-states that are sites of internal contestation for power, comprising both conflicting and converging interests of different stakeholders. The foreign policies of both India and Sri Lanka are largely formulated by a small elite group involving the head of government, some key Cabinet ministers, and a few top bureaucrats/technocrats. Often the Foreign Ministry or the Trade Ministry is ignored altogether by this small elite group in formulating foreign/trade policy. However, this is more so in the case of Sri Lanka than India, given the latter's greater size and complexity, the stronger checks and balances in place, and its central-state government dynamics. The ILA process has been largely driven by powerful elites in government in both India and Sri Lanka, with some involvement of the private sector, and almost no involvement of civil society.

### ***2.2.3 The Realist-Liberal Synthesis***

While a realist analysis of world politics focuses on nation-states, their interests and security priorities within an anarchic international sphere, at the other end of the spectrum, the liberal tradition sees a reduction in conflict via trade relations, transnational and institutional linkages, and an increase in economic interdependence of the world. This liberal view is the foundation for much of

the study of regional integration (Nye 1988: 239-240; Grieco 2000 18-19). Keohane and Nye (2001: 20-32), through their concept of 'complex interdependence', project a synthesis of realist and liberal traditions by highlighting the importance of institutions/regimes in building economic and other forms of interdependence, and thereby positively transforming bilateral relations and reducing military conquest. This synthesis of realist and liberal dialectic has opened up greater possibilities for explanation of global phenomena. I have applied this framework to the transformation in India's neighbourhood policy following the neoliberal convergence in the region. The latter can be conceived as a means of overcoming the security dilemmas in South Asia, even though the end objectives of states remain geopolitical.

Much of the transformation and interdependence taking place between nation-states can be explained via this complementarity between realist and liberal traditions. It incorporates a thesis of the state's self interests as well as a transformation and accommodation of the interests of other states (Nye 1988: 238). Nevertheless, in my view the liberal tradition has limitations and is useful in explaining the transformative process but not the outcome. The realist tradition clearly prevails, because even when states transform their interests through economic interdependence, they simultaneously increase their military power and become stronger.

#### ***2.2.4 The Political Economy and Ideology of Neoliberalism***

The impact of neoliberalism on India's neighbourhood policy is central to my research and, at one level, the ILA can be seen as an outcome of its neoliberal project. I have analysed neoliberalism from a state-centric realist IPE perspective, and made use of the analyses posited by Robison (2006: 3-19), Gamble (2006: 20-35) and Hadiz and Robison (2005: 220-241).

Neoliberalism is both a political economy approach and a political ideology. It denotes a relationship between the state and the market, where primacy is given to the market (Gamble 2006: 21-23). Nevertheless, the neoliberal objective of institutionalising the values of the market has a political agenda (Robison 2006: 11). Neoliberalism emerged in the 1970s both as an ideology and as a policy response to a specific crisis in western capitalism which resulted in the disintegration of the welfare state and its accompanying Keynesian ideology, and which led to the ascendance of a free market ideology influenced by neoclassical economics. The harsher, 'laissez faire' version of neoliberalism that emerged in the late-1970s/1980s, called for market forces totally unfettered by state control, and was replaced in the 1990s by a softer version. The latter acknowledged a significant role for the state in creating and sustaining institutions that were considered necessary for the free market to reach its full potential. When India started its reform process in 1991, the softer version of neoliberalism, legitimising a range of state interventions, was already in place. Neoliberalism became closely associated with the global policy agenda set by IFIs and it was aggressively prescribed for developing

countries as the ‘template of the whole world’ (Gamble 2006: 22). It has remained the hegemonic ideology.

Neoliberalism is a hybrid discourse and has many inherent contradictions (Gamble 2006: 34-35). Its key contradiction is that it demands that both the economy and the state should be simultaneously strong (ibid.). It therefore incorporates within it an unprecedented convergence of the market and politics. It has in many instances, consolidated authoritarian or populist politics and predatory economic relationships in developing countries (Hadiz and Robison 2005: 220-241). I illustrate in my research that in both Sri Lanka and India, the neoliberal project was accommodated in ways that served the interests of their powerful elites. India’s neoliberal project transformed its engagement with neighbours like Sri Lanka from invasion/coercion to economic cooperation, but it also incorporated India’s emergence as a nuclear power and a more assertive state on a nationalist platform.

For Gilpin (1986: 311-312), a liberal international economy rests on three elements that constitute its political framework. They are a dominant liberal hegemonic power; a set of common economic, political and security interests that help bind liberal states together; and a shared ideological commitment to liberal values. With neoliberal ascendancy in India, all three elements gradually become available in the Indo-Lanka relationship, although not in the whole of South Asia. India’s neoliberal project transformed its regional hegemonic role from coercer/aggressor to a more liberal hegemon. The ILA was introduced when India was gradually transforming into a liberal hegemon. According to Gilpin (2002: 165-182), a hegemon is a leader who uses its power, influence and economic/political resources to promote and maintain a liberal trade regime and a stable international system primarily to advance its own political and economic interests. The leader seldom coerces the weaker states within its sphere of influence to obey the rules, it seeks cooperation. Weaker states cooperate with the hegemon because it is in their economic and security interests to do so. The hegemonic power therefore organises its economic space in terms of its own economic and security interests (Gilpin 1971: 403). This shows that there are many nuanced variations of accommodation through which the state with less power can benefit from a relationship with a stronger state (Hurrell 1995: 51-53). Gilpin’s approach helps unpack both India’s and Sri Lanka’s interests in the ILA, as both benefit from it.

### **2.3 Summary**

The theoretical framework I adopt is an IPE approach incorporating a state-centric realist perspective, supplemented with a synthesis of realist and liberal theory. The political economy of the ILA is examined using an IPE approach. The geopolitical interests driving India and Sri Lanka are examined from a realist perspective. This is supplemented by a liberal perspective in examining the transformation of India’s neighbourhood policy via economic interdependence. The framework helps analyse how the ILA has been used as

a political instrument by both India and Sri Lanka to achieve their respective geopolitical objectives.

## Chapter 3

### LITERATURE REVIEW

#### 3.1 Introduction

The objective of this chapter is to examine how the existing literature has conceived the dynamism of the ILA. The chapter therefore reviews the drivers of the ILA as identified in the literature. For purposes of clarity and brevity, the drivers are divided into the two broad categories of ‘political’ and ‘economic’, incorporating the differing interests of Sri Lanka and India in the ILA. They are not critiqued as this is not the intent of my research.

#### 3.2 Economic Drivers

There is a large body of literature on the ILA that identifies its economic drivers. While it is divided on the impact of the ILA, with many studies perceiving it as ‘a limited success’, most agree on the type of economic drivers that have made the FTA dynamic (Wickramasinghe 2007: 31-32; Kelegama and Mukherji 2007: 05). The first section examines the economic imperatives as identified in the two WIDER studies. The second examines them as identified in the remaining literature. Considerable space is devoted to the WIDER studies, given the strong influence it had in the conceptualisation of the ILA.

##### 3.2.1 *The Wider Studies*

The ILA can be traced back to two pioneering studies that were commissioned by UNU-WIDER by Panchamukhi et al. (1993) and Jayawardena et al. (1993), on the need to evolve a preferential instrument to expand trade between India and Sri Lanka. The study by Jayawardena et al. (1993) became the framework for the conceptualisation of the FTA in 1998. It projects a rational argument for a reciprocal trading arrangement between India and Sri Lanka, from a largely Sri Lankan perspective.

The two studies identify the trade imbalance between India and Sri Lanka and the latter’s burgeoning trade deficit with India as the major justification for implementing a preferential trading instrument. Jayawardena et al. (1993: xi-xii) argue that, with economic reforms in India, the country’s imports to Sri Lanka increased rapidly from the early-1990s and became broadbased, whereas the reverse did not happen. Conversely Sri Lanka’s exports to India stagnated within a narrow product range, comprising traditional exports, despite an otherwise steady shift in its export basket from primary commodities to manufacturing (*ibid.*). Taking note of this, Jayawardena et al. (1993: xi) made a strong argument for the creation of a ‘fast-track’ instrument to ‘dismantle’ trade barriers and stimulate Indo-Lanka trade

The key argument they proposed was that Sri Lanka should serve as an entry to foreign investment from India as well as third countries, taking advantage of the preferential tariff scheme to access the then largely protected Indian market. Sri Lanka would serve as an export platform from which the product of joint ventures would be (re)exported to India. From Sri Lanka's perspective, trading with South Asia was seen as synonymous with trading with India, which was perceived as the 'the core around which a dynamic and regional market' could be created (Jayawardena et al. 1993: 24).

Jayawardena et al. (1993: 17) acknowledged the possible erosion of advantage of the ILA for Sri Lanka in the long term with the gradual reduction of import tariffs to MFN level. The study therefore argues that the ILA would be exploiting the tariff differential between a liberalised Sri Lanka and a protected India in the short-to-medium term, and 'first mover advantage' was emphasised.

Their study also emphasised the 'distinct reciprocity of interest in promoting mutual trade', and posits a credible economic argument for India to enter into a preferential arrangement with Sri Lanka (ibid.). It argued that India benefitted from Sri Lanka's emergence as one of the fastest growing markets for Indian exports in the early-1990s, as a result of the early liberalisation of its trade regime. It was further argued that SAARC countries, including India, needed to diversify their market instead of relying on the OECD market where growth was decelerating with a corresponding increase in protectionism in the 1990s. The WIDER studies were undertaken in the backdrop of a world that was fragmenting into regional trading blocs, where no region wanted to be excluded. They implied that India should seek its own trading bloc in the region.

### ***3.2.2 Other Literature***

Other studies identify several economic drivers of the ILA. Many early studies reiterated arguments posited by Jayawardena et al. (1993) but, with the increasing liberalisation of India, the argument shifted from exploiting tariff differentials to exploiting competitive advantage. The drivers inherent in this thinking are mapped in brief below:

The overarching economic imperative from Sri Lanka's perspective was the growing Indian market (Jayatissa and Thenuwara 2000:04; Kelegama and Mukherji 2007: 02; Yatawara 2007: 220; Kelegama 2008: 1-2). Trading with the region was tantamount to trading with India and Sri Lanka's main interest was to gain access to the Indian market by exploiting its location advantage. It was also driven by a desire to induce a transformation of its exports from low- to high-value-added goods, and to increase the availability of cheaper consumer imports from India (Jayatissa and Thenuwara 2000: 03-04; Kelegama and Mukherji 2007: 02). Kelegama (2003: 3153-3154) argued that the ILA was

driven in the short-to-medium term, by the exploitation of immediate market niches, though with low-value addition.

The ‘first mover’ advantage that Sri Lanka enjoyed in accessing the largely protected but vast Indian market, was identified as providing impetus to the ILA at the time of its inception (Jayatissa and Thenuwara 2000: 04; Weerakoon 2001: 627-629; Wickramasinghe 2007: 04; Kelegama and Mukherji 2007: 02; Yatawara 2007: 219-220; Kelegama 2008: 08). As Sri Lanka liberalised its economy 14 years before India, the tariff differences between the two countries and Sri Lanka’s location advantage were expected to attract FDI from third countries seeking to enter the Indian market. Vanaspati, copper, bakery shortening/margarine, marble industries are products for which Indian companies set up ventures in Sri Lanka to buy back for the duty-free Indian market (Kelegama and Mukherji 2007: 17; Yatawara 2007: 242).

Other arguments identified as having driven the ILA include the following:

- The invigoration of dormant regional complementarities, investment and FDI, that led to a new comparative/competitive advantage to trade with one another, to specialise and exploit economies of scale (Jayatissa and Thenuwara 2000: 04; Kelegama 2003, 2006a: 300-301; Kelegama and Mukherji 2007: 05).
- The liberalisation policies implemented independently by India and Sri Lanka that invigorated the natural market integration process, and led to spillovers on the services sector (Kelegama 2006a: 301; Kelegama and Mukherji 2007: 20; Kelegama 2008: 12).
- The large scope for expansion of new products that Sri Lanka had not previously exported to India (and, to a lesser extent, from India to Sri Lanka) due to political economy pressures against preferences that operate against existing imports from partner country (Baysan et al. 2006: 6-7).
- The special and differential treatment written into the ILA, acknowledging the vast asymmetries between India and Sri Lanka, and thereby conferring benefits on the smaller economy (Kelegama 2006a: 296; Kelegama and Mukherji 2007: 37).

There is a regional and an extra-regional argument cited as having driven the ILA during its inception. The regional argument affirms that the stagnation of SAPTA, and the corresponding absence of a dynamic regional framework, provided new impetus to the ILA and the bilateral track (Weerakoon and Thennakoon 2008: 135-149; Kelegama 2006a: 301; Kelegama and Mukherji 2007: 03; Wickramasinghe 2007: 04). The extra-regional argument sees the ILA as having been driven by the global proliferation of regional and bilateral trading arrangements that emerged in the 1990s, partly due to the failure of the multilateral trade regime (Jayatissa and Thenuwara 2000: 03; Sri Lanka Development Policy Review 2004: 43; Baysan et al. 2006: 09). The argument is that both India and Sri Lanka needed to enter into a

preferential arrangement to avoid being excluded from increasingly protectionist blocs in global trade (*ibid.*).

A key argument that emerges in many studies is that the economic benefits of the ILA for Sri Lanka far exceeded the benefits for India (Panagariya 2003: 12-17). Wickramasinghe (2007: 11-13) contests this view to some extent by indicating that for India, in certain sectors, such as vehicle exports, Sri Lanka was an important trading partner. Kelegama (2006a: 301) reiterated this position by observing that India was actively seeking southern markets in 1998, after the US imposition of economic sanctions following its nuclear tests (Kelegama 2006a: 301; Kelegama and Mukherji 2007: 2).

While most studies saw the ILA as a state-driven process, Kelegama (2006a: 295; 2008) and Kelegama and Mukherji (2007: 02) perceive it to be driven to some extent by the private sectors of both countries seeking new markets in the region. In Sri Lanka, the private sector applied pressure on the government to sign the ILA, due to the stagnation of SAPTA.

Most of the drivers cited above are complementary and project economic arguments that had political resonance with regimes in power, and thereby had an impact on the conceptualisation of the ILA. They also show how the ILA became dynamic by exploiting certain loopholes connected to the tariff differential between the two countries, and how the SDTs worked in favour of Sri Lanka.

### **3.3 Political Drivers**

The political drivers cited in the literature contain the underlying premise that regional cooperation does not promise high economic incentives for India, and that its interests have a strong geostrategic component. Almost all studies acknowledge that in addition to the economic drivers, there is a strong political intent to the ILA. However, no study has elaborated on its geopolitical and strategic imperatives. The political drivers mapped in the literature are presented below:

Jayawardena et al. (1993: 16-19) acknowledged the strong political intent of the proposed FTA by observing that the purely economic benefits to India ‘though not insubstantial... may well be perceived to be a weak motivation’. They argued that the benefits for India could be seen to be more substantial if viewed in the context that ‘reciprocal trade preference would make a contribution to political and economic stability of Sri Lanka in which India has a major stake’ (Jayawardena et al, 1993: 19). They also saw Indo-Lanka economic cooperation as ‘inevitable’, given the ‘growing convergence of economic objectives and policies’ and ‘interests that embrace political and economic matters’ (*ibid.*). The study positioned trade in the backdrop of economic integration and regional stability, conceived as key geostrategic



imperatives for India. It acknowledged India's direct stake in Sri Lanka's security.

A similar position is presented by Kelegama (2006a: 301) and Kelegama and Mukherji (2007: 37) who noted that the ILA was driven by India's belief that economic benefits to the periphery could alleviate political problems. The Sri Lanka Development Policy Review (2004: 43) argued that closer economic cooperation with India in the form of the ILA was considered essential for consolidating political relations between the two countries and thereby helping resolve Sri Lanka's civil conflict.

Weerakoon and Thennakoon (2008: 145) observed that the ILA is driven by both political and economic considerations. They posit the political driver above the economic by arguing that the failure of SAPTA was derived from the lack of political commitment to regional integration in South Asia, even while it provided an economic impetus to implement the ILA.

Another strong political argument is that the ILA was driven by India's need to project to the neighbourhood and to the world a 'role model' of success in the region (Kelegama 2006a: 300). It was driven by the desire to dispel the fear prevalent among its neighbours, that economic cooperation with a large country like India would not benefit a smaller country like Sri Lanka (*ibid.*).

Panagariya (2003: 01), Kelegama (2006a: 301 and 2008: 1) and Weerakoon and Thennakoon (2008: 135-149) identify political factors as having influenced the launching of the ILA in 1998, especially the escalation of political tension between India and Pakistan and India's desire to gain stability in the neighbourhood and simultaneously isolate Pakistan.

### **3.4 Summary**

Existing studies on the ILA deal with its economic imperatives. Most briefly acknowledge strong political drivers behind it, but there has been no comprehensive study of geopolitical imperatives.

A compelling economic argument is posited for Sri Lanka to enter into the ILA, but not for India. Many studies imply that Sri Lanka's economic benefits from the ILA far exceed those for India. However, the political driver of achieving bilateral integration and regional stability via economic integration is identified by many studies as the added incentive for India. The economic driver therefore appears to be more compelling for Sri Lanka, but it seems to be complemented by a political driver for India.

## **Chapter 4**

# **POLITICAL ECONOMY OF THE ILA**

### **4.1 Introduction**

This chapter examines the political economy of the ILA. It traces its trajectory from its origin to the measures taken to upgrade it to CEPA, its characteristics, the resistance posed to the ILA/CEPA process, and its dynamism in the backdrop of a stagnant SAPTA/SAFTA. The ILA/CEPA is examined from the perspectives of both India and Sri Lanka, and is largely conceived as a state-centric process. How the interests of various groups that comprise the state, including political leaders, diplomats/technocrats, and at times the private sector, converge or diverge and impact the ILA/CEPA process is also examined.

### **4.2 Origin of the ILA**

The ILA is a reciprocal preferential trading arrangement, introduced by India and Sri Lanka to increase bilateral trade between the two countries. At the time the FTA came into effect, there were two distinct features of Indo-Lanka trade, namely, a low volume of bilateral trade and a persistent balance of trade in favour of India (Weerakoon 2001: 627). India's exports to Sri Lanka were highly diversified, whereas Sri Lanka's exports to India were concentrated in a limited number of items confined to traditional exports and primary commodities (ibid.).

The ILA was signed in December 1998 during a bilateral visit of Sri Lanka's President Kumaratunga to India. It came into effect in March 2000. The process of negotiation was completed hurriedly within a few months (Weerasinghe, p.c.).<sup>1</sup> Weerakoon (2001: 629) indicates the products were to be named within 60 days of signing. However, the exchange of lists (annexes) was delayed until March 2000 for various reasons. She (p.c.) observes that the speed with which the negotiations were completed was surprising.

Even though the FTA was signed in 1998, its conceptualisation took place earlier and can be traced to the two WIDER studies by Panchamukhi et al. (1993) and Lal Jayawardena et al. (1993.) Between 1985 and 1993, Jayawardena (Director of UNU-WIDER and an eminent Sri Lankan economist) chaired a study group on Indo-Sri Lanka Economic Cooperation, the final report of which (Jayawardena et al. 1993) formed the basis of the ILA some five years later.

Although India embarked on its economic reform in 1991, it was implemented slowly (Bhagwati 1998: 36-37) and India was still a protected

economy by even the mid-to-late-1990s (Udagedara and Kumar, p.c.). Sri Lanka, on the other hand, had liberalised its economy much earlier in 1977 and its external trade regime in 1998 was far more liberal than that of India, with nearly 70 percent of products subject to a nominal import tariff of only 10 percent. This meant that Indian imports were already price competitive in Sri Lanka prior to the ILA (Weerakoon 2001: 628). The perception on the Sri Lankan side was that there was a lack of a 'level playing field' in two-way trade, and that the protected market of India was taking advantage of the low import tariffs in an already liberalised Sri Lankan market without reciprocity. The persistent trade imbalance in the 1980s to early-1990s was viewed by Sri Lanka as reflecting the 'imbalanced bilateral relations' between the two countries, and it was consistently brought up by the Sri Lankan side during bilateral discussions and annual consultations, and became an 'irritant' to India (Weerasinghe and Dhanapala, p.c.).

It was precisely when Indian policymakers were under pressure to respond positively to this trade imbalance with a smaller neighbour, that Jayawardena et al. (1993) posited a compelling economic rationale for a bilateral PTA by exploiting the tariff differentials between the two countries, thus reducing the perennial trade imbalance. The argument was that Sri Lanka, with its limited market, could use the FTA to attract investment from India and from third countries, set up joint ventures in the liberal economic climate in Sri Lanka whose products could then be (re)exported to the largely protected but dynamic Indian market (Jayawardena et al. 1993: 1-4). This argument had immediate political resonance with the new government led by President Kumaratunga (Athukorala and Jayasuriya, p.c.). Given India's growing middle class and correspondingly expanded market, Sri Lanka viewed trading with South Asia as equivalent to trading with India. Projecting Sri Lanka as a gateway to South Asia became a favourite slogan of the Kumaratunga PA government which came into power in 1994, unlike the UNP regime in 1977, on a political rather than an economic mandate. A free market economic strategy that had strong political resonance with the constituency was of crucial importance to the PA, which had a legacy of autarkism in the pre-1977 period. It offered a way of politically outmanoeuvring the opposition UNP's neoliberal free-market ideology, which the latter had cleverly manipulated to retain power for 17 years. Jayawardena et al. (1993: 1-2) were motivated by the East Asian experience, and they envisioned Sri Lanka playing a role vis-à-vis the vast Indian subcontinent, similar to that of Hong Kong vis-à-vis mainland China, and Japan vis-à-vis East and Southeast Asia. This vision of economic integration with India also resonated well with the PA foreign policy, as the coalition government's main party, the SLFP, had historically maintained the best of relations with India and with the Congress party. Soon the Sri Lankan technocracy was under political pressure to translate this market access instrument into India into reality (Weerasinghe, p.c.).

The initial interest in and conceptualisation of the ILA therefore emanated from the Sri Lankan side (Udagedara and an Indian diplomat, p.c.). Increased economic cooperation between India and Sri Lanka had already commenced

by this time, with the inauguration of the Indo-Lanka Joint Commission in 1991, and the signing of an Agreement on Promotion and Protection of Investments in 1997. But the Indian side showed no interest in the FTA until the latter part of 1998 (Weerasinghe, p.c.). India's new BJP-led government assumed office in April 1998, and carried out nuclear tests in May. This was immediately followed by Pakistan's nuclear tests, and the process resulted in the imposition of a series of nuclear-related sanctions on India by the Clinton administration (Tellis 2007: 233-236). Faced with the possibility of global isolation, the BJP-led government resorted to every foreign policy avenue available to win new friends and to isolate Pakistan politically. The ILA was both an instrument for engaging Sri Lanka, perceived as Pakistan's traditional neighbourhood ally, and a way of isolating Pakistan within the region (Rodrigo and Weerasinghe, p.c.). Consequent to this thinking, Weerasinghe (p.c.) observes that Menon, India's High Commissioner in Sri Lanka during this period, approached Jayawardena, then Presidential Economic Advisor, regarding a possible bilateral FTA. Kelegama's (p.c.) argument that India, facing economic sanctions, was also driven by a need to seek markets in the neighbourhood, may have been an immediate economic imperative, but not in my view a compelling reason to sign the ILA. Sri Lanka with a population of 18.7 million was a miniscule market for India. Today, even if the totality of Sri Lanka's exports were to go to India, it would only comprise 2.5% of its total imports. Sri Lanka did not provide a compelling economic rationale for India to enter into the ILA.

By 1998-2000, India was becoming increasingly confident of its own economic potential, following deregulation of its economy (Kelegama, Weerakoon and Jayasuriya, p.c.). The ILA provided India with an opportunity to develop a new economic model to be tested in the neighbourhood, and Sri Lanka offered a small enough economy for the purpose (Kelegama and Sri Lankan diplomat, p.c.). The smaller economies of Nepal and Bhutan were already integrated with India via non-reciprocal trade agreements. A trade agreement with either Bangladesh or Pakistan was not an option given the less-than-friendly bilateral relations. This left only Sri Lanka, which at the time was a friendly neighbour, with a liberal economy, enthusiastic to integrate with the Indian market.

Moragoda (p.c.) argues that the strong ideational drive emanating from Sri Lanka was not sufficient, and that 'an international breakthrough' was needed if the ILA were to come to fruition. This was provided by the personal links established between the political leadership and elite technocracy of India and Sri Lanka at this time (ibid.). The Kumaratunga government including Foreign Minister Kadirgamar had excellent personal relations with Prime Ministers Gujral and Vajpayee. Sri Lankan and Indian bureaucrats and diplomats (p.c.) also referred to Lal Jayawardena's friendship with Congress-led government's Finance Minister Manmohan Singh, and Indian finance/planning technocrats like Ahluwalia and Sengupta, as having set the foundation for the ILA.

### 4.3 Key Features of the ILA

Two features of the ILA made it unique. First, the two countries wanted a meaningful trade preference scheme covering a substantial proportion of trade, while each country's sensitive sectors remained protected.<sup>2</sup> As they wanted to avoid the slow positive list approach adopted by SAPTA, they accepted Jayawardena et al.'s (1993: vii-viii/21) proposal that the problem of sensitive sectors should be overcome by maintaining a negative list. This placed the ILA on a faster track than SAPTA.

Second, the vast asymmetries between Sri Lanka and India in terms of geography, economy<sup>3</sup> and population were accommodated by the Special and Differential Treatment (SDTs) in the Agreement, which gave special concessions to Sri Lanka as the smaller economy (Kelegama 2008: 2). The SDTs involved Sri Lanka maintaining a larger negative list, including full protection of its agriculture sector, and a longer tariff phase-out period of 8 years; India maintaining a shorter negative list and a shorter tariff phase-out period of 3 years; relaxed Rules of Origin (ROO) of only 35 percent value addition (and 25 percent value addition if Indian inputs were used); negative list reduction being based on Sri Lanka's comfort level; and Sri Lanka's high-revenue imports not being subject to tariff preference. (ibid.):

### 4.4 Liberalisation and Protection in the ILA

Regardless of concessions, a key characteristic of the ILA has been its fluctuation between liberalisation and protectionism. Weerasinghe (p.c.) observes that asymmetries are not reflected in all elements of the ILA, and India has remained quite protectionist (Weerasinghe, p.c.). While the Sri Lankan delegation negotiated hard to keep its agricultural sector protected, there was continuing pressure from the Indian side to liberalise it (Jayasundera, Weerasinghe, p.c.). Similarly, despite efforts, the Sri Lankan delegation did not succeed in removing non-tariff barriers (NTBs) from the ILA during the negotiation process, due to the intransigence of the Indian delegation (Weerasinghe, Jayasundera, Udagedara, Wijayasiri, p.c.). The absence of a mechanism to effectively address India's non-tariff/para-tariff barriers and institutional impediments, such as port-entry restrictions, state-level taxes, customs procedures, and health and sanitary regulations (despite Sri Lanka's repeated attempts to introduce one) has therefore become a key weakness in the ILA. This has hampered its progress, and its upgrading to CEPA.

Additionally, although the concessions India offered to Sri Lanka under the ILA look generous, a closer examination reveals that the products Sri Lanka is capable of exporting to India are either excluded through the negative list or constrained by quota. The ROO requirements further restrict its main exports. Baysan et al. (2007: 4-7) note that 'the politics of exceptions' is clearly stacked against goods in which Sri Lanka has a comparative advantage, and in sectors where trade creation is most likely. Much of the trade expansion therefore

comes from a small number of new low-value-added products, concentrated in a few sectors, that were not previously exported by Sri Lanka to India, or traded very little (Baysan et al. 2006: 04-07; Yatawara 2007: 219; De Mel 2008: 13). Just two tariff lines, vanaspati and copper products, contribute 50 percent of Sri Lanka's exports to India (de Mel 2008: 12; Kelegama and Mukherji 2007: 21). Sri Lanka thus continues to specialise in a narrow range of exports without adequate value addition and technology transfer, even though India has further diversified its production structure in the recent past (Wickramasinghe 2007: 26). The trade balance between the two countries continues to remain heavily in favour of India.

The surge in new exports from Sri Lanka to India, which has exploited the differential tariff structure between the two countries, has drawn several countervailing measures from the Indian government such as TRQs, canalisation, or other institutional barriers, on the grounds that the imports are 'injurious' to Indian domestic industry (Wickramasinghe 2007: 27; Kelegama 2006a: 297-299; 2008: 5). It has taken these measures in response to domestic pressures emanating from influential local industry lobbies, such as the pepper lobby in Kerala. This coexistence of tariff concessions with protectionist measures, in the ILA, point towards the co-existence of economic reforms with old subsidy and patronage networks in India's neoliberal project (Mooij 2005: 30). Athukorala (p.c.) notes that the continuation of countervailing measures from the Indian side, subsumes the ILA's economic benefits and highlights India's 'half-hearted trade policy reforms' and the efficacy of its political rhetoric.

There is however evidence that, recently, India has begun responding more positively to Sri Lanka's call for the removal of NTB/ROO restrictions under the ILA. India's removal of ROO and port restrictions for 6 million pieces of ready-made-garment and 15 million tonnes of tea exports from Sri Lanka, by April 2008, is an example. India has recently also begun setting up customs nodal centres in selected southern Indian ports, the effectiveness of which is reflected in the lower number of complaints received by Sri Lanka's Commerce Department from local exporters about entry restrictions to India (Udagedara and Dharmapriya, p.c.). According to Sri Lanka's Export Development Board, several outstanding institutional barriers in India have already been resolved following notification to the Indian authorities (Tudugala 2008). Udagedara (p.c.) observes that India is now cooperating with Sri Lanka to resolve problems with the ILA, more as 'a goodwill gesture' than for economic benefit.

#### **4.5 Upgrading the ILA to CEPA**

The CEPA process offers interesting insights into the political economy of Indo-Lanka relations. Given the ILA's dynamism in increasing bilateral trade, investment and services, the two governments decided to upgrade it to a CEPA covering investment and services, during an official visit to India by Sri

Lanka's Prime Minister in June 2002. Weerakoon, Udagedara and Kumar (p.c.) cite the dynamism of Sri Lanka's services sector over trade, with the former comprising 55 percent of Sri Lanka's GDP, as the rationale for upgrading the ILA to CEPA. The CEPA was described by the Indo-Lanka Joint Study Group as a move that would take the two countries to 'a qualitatively new level of engagement' by deepening 'bilateral economic cooperation' (JSG Report 2003). It was negotiated on the same premise of asymmetric reciprocity which guided the ILA, by acknowledging India's willingness to liberalise more than Sri Lanka, moving at a pace in accordance with Sri Lanka's comfort level, and taking proactive measure to facilitate Sri Lankan exports to India.

The comparison of ILA and CEPA processes offers interesting insights into the political economy of Sri Lanka during two different periods, with different political parties in power with different political ideologies. The SLFP (the main party of the PA coalition) and the UNP are the two main political parties and have governed Sri Lanka alternately, albeit in coalition with smaller parties. Coalition governments became a feature of both Sri Lankan and Indian politics from the 1990s and led to weak governments that became increasingly vulnerable to the concerns of their domestic constituencies. The ILA was launched when the more inward-oriented PA was in power, while CEPA negotiations began in 2002-2003 when the more neoliberal, pro-western UNP was in power, sharing an uneasy cohabitation with President Kumaratunga from the opposition.

The pro-neoliberal UNP led by Prime Minister Wickremesinghe had a coherent vision of India, and viewed it as the 'fourth pillar' of Sri Lanka's economic policy (Kelegama, p.c.). Moragoda (p.c.), who was the key strategist in the Wickremesinghe government in 2002-2004, notes that Wickremesinghe saw Sri Lanka's economic integration with India resulting in its emergence as the hub of South Asia. But this vision of Sri Lanka emerging as a regional hub for third country investment into India did not materialise during the UNP regime of 1977-2004, nor during the PA regime of 1994-2001. Instead, Dubai and Singapore emerged as regional hubs, and Sri Lanka with its protracted ethnic conflict remained forgotten. Nevertheless, the UNP which was in office in 2002-2004 envisaged deeper economic integration with India by upgrading the ILA to CEPA, as a means of 'regaining Sri Lanka's lost advantage' via connectivity with India (ibid.).

Moragoda (p.c.) observes that, while Sri Lanka's interest in the CEPA was overwhelmingly economic, India had a geopolitical interest in upgrading the ILA to CEPA. India's BJP-led government was 'very keen' on the CEPA, and both Prime Ministers Vajpayee and Wickremesinghe wanted it concluded and operational by 2004. Moragoda (p.c.) sees the dynamism of the CEPA process as personality driven. He notes that the Vajpayee government worked well with the Wickremesinghe government, and the personal chemistry between the two leaders and between Moragoda himself and the Indian leaders in office during 2002-2004, including Yashwant Singh (External Affairs Minister) and

Jaswant Sinha (Finance Minister), were 'excellent'. Thus, according to Moragoda the ideational push for the CEPA, as with the ILA, emanated from the Sri Lankan side.

The CEPA process offers an interesting parallel between India's Vajpayee government and Sri Lanka's Wickremesinghe government in 2002-2004 (Kelegama, p.c.). Both governments took neoliberalism to a new high with their free-market policies, both used catchy slogans, i.e., 'India Shining' and 'Regaining Sri Lanka', to market neoliberalism to their respective constituencies and both governments were swept out of power in 2004. Even so, the CEPA process continued under the new governments of President Kumaratunga and Prime Minister Manmohan Singh that came thereafter.

The CEPA negotiations were satisfactorily concluded by India and Sri Lanka after 5.5 years, 13 rounds and substantial delays in July 2008. According to the Sri Lankan Commerce Department, Ceylon Chambers of Commerce and Kelegama (p.c.), the negotiations, unlike those of the ILA, were detailed, transparent, and all stakeholders were consulted. Nevertheless, the CEPA became a political rather than an economic decision for both governments, when the signing (scheduled for 3<sup>rd</sup> August 2008) was indefinitely postponed at the last minute. This was because of concerns expressed by a small group of Sri Lankan entrepreneurs who had bitter experiences in accessing the Indian market via the ILA, and by two Marxist, Sinhala-nationalist political parties in the opposition, the JVP and the NFF. The entrepreneurs opposed it on the grounds that the ILA's deficiencies with regard to NTBs and other institutional impediments should be resolved prior to it being upgraded to CEPA. The two political parties opposed it on the grounds that Indian imports/services would swamp local industry/services and erode their competitiveness. The Sri Lankan bureaucracy was also divided on the merit of CEPA. Kelegama and some Commerce Department officials (p.c.) expressed disappointment at the postponement, while some others (p.c.) expressed the fear that the CEPA could make Sri Lanka too dependent on the Indian market, a situation that could be abused by India for its political advantage. Former Finance Secretary Jayasundera (p.c.) placed emphasis on the politics of economics and spoke of the need to ride the fine balance between economic reform and public consent of reforms.

The resistance was also driven by Sri Lanka's fear that India would use its economic dominance over a small state for political subjugation. The 'anti-India' slogan has political resonance in Sri Lanka, and is consistently abused by weak coalition governments to gain favour with the electorate. On the other hand, it is an expedient excuse that can be used by governments keen to defer integration with India due to foreign policy compulsions. The current more inward-oriented Rajapaksa government's instructions to a group of policy implementers 'to go slow' on the CEPA negotiations (Sri Lankan bureaucrat, p.c.) is reflective of this ambiguous political economy.



India, in contrast, has shown a consistent interest in signing the CEPA. It has vigorously marketed it by projecting it as an opportunity. In July 2008, India's Commerce Secretary Gopal Pillai urged the Sri Lankan private sector to look at the CEPA from the perspective 'that India is a huge market (with over a billion people) to be exploited' (Pillai 2008). From India's side, there were indications that some pressure was applied on the Sri Lankan government to sign the CEPA (Balachandran, p.c.). To achieve this end, the Indian government was 'willing to be generous' (Kelegama, p.c.). Hence under CEPA negotiations in the services chapter, India offered its entire Doha list to Sri Lanka, scheduling fifteen sectors, while Sri Lanka scheduled only eight. Economic asymmetry was also formerly written in as a principle in CEPA, while it was only acknowledged but not written into the ILA (Udagedara, p.c.).<sup>4</sup> India was therefore 'disappointed' that bilateral cooperation could not be taken to a new and deepened level by implementing the CEPA (Indian diplomats, p.c.).

#### **4.6 Failure of the Multilateral Track**

The dynamism of the ILA gains prominence against the backdrop of the stagnation of SAPTA and its successor SAFTA, the regional trading arrangement within SAARC. SAPTA and SAFTA have not stimulated any change in existing trade patterns in South Asia, and intra-SAARC trade has stagnated at 5 percent of total trade with the rest of the world (Weerakoon and Thennakoon 2008: 138).

Many economic and political reasons have been cited for the failure of SAPTA/SAFTA. From an economic perspective, the critical weakness identified is the very limited scope of free trade envisaged by the Agreements (Weerakoon and Thennakoon 2008: 138-142; Kelegama 2007: 21-29 and 2008: 5). Under SAFTA, almost 53 percent of total imports in South Asia, including the most actively traded goods, are subject to sensitive lists, and thus excluded from trade (Weerakoon and Thennakoon 2008: 135-142). The long tariff phase-off period and the lack of binding provision for the phasing off of negative lists over time, are other impediments (ibid.). If one were to compare SAFTA with the ILA, only 13 percent of Sri Lankan exports to India fall in the sensitive list under the ILA, while 42 percent of Sri Lankan exports are exempt from the tariff liberalisation programme under SAFTA (de Mel 2007: 2). SAFTA also has a slow, positive-list approach, as opposed to the ILA's negative-list approach.

The larger debate in which the ILA is placed is on whether it would subsume or complement the multilateral track. Weerakoon and Thennakoon (2008: 135-149) and Kelegama and Wijayasiri (p.c.) argue that the ILA has already fragmented and subsumed the SAFTA process and will continue to do so. Sri Lanka's diplomats and technocrats Jayasinghe, Udagedara and Dharmapriya (p.c.), agree, and indicate that Sri Lanka has received all concessions it needs under the ILA, which has 'rendered SAFTA redundant'.

Politics is identified as a main reason for the failure of the multilateral track. When the ILA was launched in 1998-1999, SAARC had come to a virtual standstill, as a result of heightened tension between India and Pakistan following the nuclear tests, the Kargil conflict and a coup d'état in Pakistan which put a military regime in power. The rapid deterioration in Indo-Pakistan bilateral relations saw the postponement of SAARC Summits for the next three years, and an increasing lack of commitment to regional integration. Rodrigo (p.c.), who was SAARC Secretary-General during 1999-2002 observes that his tenure was 'overshadowed by the India-Pakistan nuclear rivalry' and led to slow progress in SAARC.

Indian and Sri Lankan diplomats and technocrats (p.c.) argue that, today, SAFTA is impeded by Pakistan and its stance as a 'difficult negotiator' (Annex 3[4-3]). India unilaterally extended MFN status to Pakistan in 1994, but Pakistan did not reciprocate. This has complicated the tariff liberalisation process within SAFTA, and resulted in Indo-Pakistani reluctance to multilateralise concessions that have been granted bilaterally. Both India and Pakistan have maintained larger negative lists under SAFTA compared to their bilateral agreements with Sri Lanka (Weerakoon and Thennakoon 2008: 146-147).

To overcome this impediment and still achieve regional integration, India has begun circumventing the multilateral track by granting increasingly generous tariff concessions to its neighbours other than Pakistan, both unilaterally and bilaterally. Sri Lanka, Nepal and Bhutan have already obtained favourable access to the Indian market bilaterally, and future arrangements will grant similar benefits to Bangladesh (Weerakoon and Thennakoon 2008: 146-147). In 2008, India unilaterally granted zero duty on all items covered under preferential trade, and unilaterally reduced items on the negative list for all SAARC-LDCs (DoCI 2008). India has therefore granted more concessions to SAARC-LDCs unilaterally than under SAFTA, and these are as generous as its concessions to Sri Lanka under the ILA (Kelegama and Weerakoon, p.c.). This ironically, leaves only Pakistan to gain from SAFTA (Kumar, p.c.). This also points to a trend whereby economic cooperation in the SAARC region will soon approximate free trade except for Pakistan (Weerakoon and Thennakoon 2008: 146-147). Figure 1 illustrates this trend towards India-centric convergence around the unilateral/bilateral tracks, excluding Pakistan, in regional economic cooperation.

A compelling reason for India's grant of unilateral and bilateral concessions to its neighbours today is therefore its inability to do so multilaterally rather than its wish to privilege bilateralism over multilateralism, as in its pre-liberalisation phase. Weerasinghe, Kelegama and an Indian diplomat (p.c.) observe that India is keen to see SAFTA work and wants both tracks. But with SAFTA showing no likelihood of liberalising trade within SAARC, there remains a compelling rationale for the continuing dynamism of the bilateral track and the ILA.

## 4.7 Summary

There was a strong economic argument that emanated from Sri Lanka driven by a desire to expand its contours of regional trade as well as narrow the persistent bilateral trade imbalance via preferential access to the vast and growing Indian market. This argument had strong political resonance with weak Sri Lankan coalition governments. India did not have as compelling an economic rationale to integrate with the Sri Lankan market. Nevertheless, successive Indian governments showed interest in signing the ILA and CEPA, and provided increasing unilateral and bilateral tariff concessions to Sri Lanka and its other neighbours except Pakistan, to deepen economic integration. India also highlighted its benefits to the smaller economy.

The ILA/CEPA process highlights the political economy ambiguities of Indo-Lanka relations. Despite the incorporation of special and differential treatment into the ILA, there is a co-existence of liberal and protectionist tendencies in it. This is illustrated by the protectionist characteristics exhibited by India whenever it is under pressure to safeguard domestic industry, and by Sri Lanka reneging on its promise to sign the CEPA due to resistance posed by certain local lobbies. Additionally, the degree of interest Sri Lankan governments have shown in the ILA/CEPA process, has varied according to compulsions of domestic constituencies, coalition politics and their respective foreign policy orientations. India on the other hand, has shown a consistent interest in deepening integration with Sri Lanka through the ILA/CEPA. A compelling rationale for this is its inability to do so multilaterally, because of problems with Pakistan. There is therefore an emerging trend towards free trade in the SAARC region, centred on India, excluding Pakistan.

## **Chapter 5**

# **GEOSTRATEGIC NEOLIBERALISM AND INDIA'S NEW NEIGHBOURHOOD POLICY**

### **5.1 Introduction**

This chapter places the ILA in the broader context of India's neighbourhood policy. It traces the transformation of India's neighbourhood policy following the ascendance of neoliberalism in India in the post-1991 period, and analyses the impact of its new neighbourhood policy on the ILA. The first part traces India's transformation from realist to a more accommodative power, incorporating a confluence of geostrategic and neoliberal ideology. The second part examines the synthesis of India's new neighbourhood policy with the ILA. I have used personal interviews and Indian/Sri Lankan foreign policy speeches with other secondary data, in developing this section.

### **5.2 Neighbourhood: First Circle of India's Foreign Policy**

India conceives its foreign policy in terms of a series of concentric circles. The neighbourhood comprises the 'first circle' (Sinha 2003, Annex 3[3-2]). I use the phrase 'India's neighbourhood policy' to mean only South Asia. The extended neighbourhood of Southeast Asia is excluded.

By conceiving the neighbourhood as the first circle of its foreign policy, India has invested it with a high degree of importance. The second and third circles which comprise major powers and traditional friends and allies, respectively, are built upon the first circle, and their success depends on its success. This is because neighbourhood stability is a pre-requisite for India as a regional power, to project a credible foreign policy to the world.

### **5.3 Distinctive Features of South Asia**

Despite a shared heritage and cultural commonalities, South Asia is heterogeneous in terms of religion and ethnicity. As a result, the region emerged divided following colonial rule. Its post-colonial nation-state formation process has been ridden with conflict, the most significant among these being the Indo-Pakistan conflict over Kashmir. The latter, along with three distinctive features of the South Asian region, have significantly influenced India's neighbourhood policy.

The first is the asymmetries in terms of size and economy that have led to asymmetries in terms of power between India and its neighbours.

The second is the India-centric nature of the region, given India's geographic location at its core with all other countries surrounding it peripherally. All SAARC countries, with the exception of Afghanistan, share at least one land/sea border with India. This has led to a situation where the security concerns of all SAARC states are intertwined with those of India, and any instability in India's periphery has direct ramifications on its own security (Dash 1996: 206). In the case of India and Sri Lanka, the Tamil liberation struggle waged by the LTTE against the Sri Lankan state since 1983, has direct political and security ramifications on India, due to the ethnic affiliation between Sri Lankan Tamils and the 50 million ethnic Tamils living in the southern Indian state of Tamil Nadu. The Indian central government has had to ride a fine balance between its need to suppress the LTTE due to its fear that Tamil Eelam would stoke separatist sentiments in Tamil Nadu, and its need to appease powerful coalition partners in Tamil Nadu whose constituencies have considerable public sympathy for the LTTE cause (Sikri 2007: 15)

The third is that India's large size, central location and power have conferred on it the status of a regional hegemon. India has historically used its hegemonic position to consolidate its influence and prevent extra-regional interference in the region.

#### **5.4 Pre-1991 Period: India's Realist Policy**

Following independence from British rule in 1947/1948, India and Sri Lanka emerged as two of the first democratic nation-states of the post-colonial world, and enjoyed close bilateral relations well into the 1970s. Relations were consolidated by their shared stance and congruent role in the non-aligned movement and the close personal relations between Indian and Sri Lankan leaders, especially between India's Nehru-Gandhi family and Sri Lanka's Bandaranaike. Bilateral relations between the two countries were further consolidated given their shared position as the only two longstanding and functioning democracies in South Asia (Palihakkara, p.c.).

But for forty years until 1989, India's foreign policy was also shaped by the cold war and its own sensitivities and quest for regional dominance. The ideological divide between the capitalist west and the communist world was based on differing economic principles. Correspondingly, India's autarkic, inward looking economic policies during the cold war combined with non-aligned principles à la Nehru, led to warm relations with the Soviet Union and cold relations with the US (Burns 2007).

India's pre-1991 realist foreign policy was best reflected in the 'Indira doctrine', prevalent from mid-1960s to 1980s, which comprised the realist consolidation and concentration of the Indian sphere of influence in its neighbourhood (Kumar 2008: 4-5). The doctrine was coined after the foreign

policy practiced by Prime Minister Indira Gandhi (1966-75 and 1978-84) and was influenced by the long-held view that India's security interests 'are coterminous with those of the region as a whole' and that it therefore had a 'legitimate extraterritorial interest' to intervene in internal issues of neighbours that threatened India's 'national interest' and regional dominance (DeVotta 1998: 458-459).

The articulation of the Indira doctrine, the personal animosity that existed between Indira Gandhi and Sri Lanka's President Jayewardene, and the emerging ethnic Tamil discontent in Sri Lanka, brought an otherwise cordial bilateral relationship between India and Sri Lanka to an all-time low in the 1980s (Rodrigo, Moonesinghe and Godage, p.c.). Sri Lanka was the first country to liberalise its economy in South Asia as early as 1977. The free market economic policies implemented by the Jayewardene regime, and its increasingly pro-US foreign policy stance, were in contravention of the Indira doctrine and were viewed by India as detrimental to its interests (DeVotta 1998: 461-462). India with its autarkic policies wanted neither a Singapore emerging in its backyard, nor US engagement within its sphere of influence. The pogrom against ethnic Tamils in southern Sri Lanka in July 1983 by organised Sinhala mobs sanctioned by the regime was a watershed in Indo-Lanka bilateral relations. This provided India with the much-needed license to intervene in Sri Lanka for the next four years, in violation of Sri Lanka's sovereignty, and to prevent other foreign powers from intervening in its neighbourhood (Hariharan 2006; Balachandran, p.c.). India's strategy included further destabilisation of Sri Lanka via the covert training of secessionist Sri Lankan Tamil militant groups in Tamil Nadu, and the stationing of Indian peace-keeping troops in Sri Lanka following the signing of a Peace Accord between the two governments in 1987. In 1987, India also violated Sri Lanka's airspace by dropping relief supplies in northern Sri Lanka. The three-year operation of Indian troops in Sri Lanka under the Peace Accord, and its ignominious pullout in 1990 further skewed Indo-Lanka relations.

India's intervention in Sri Lanka, including its complicity in the island's ethnic conflict, stemmed as much from a lack of convergence in the economic policies of the two countries, as from the desire to remove the threat of US influence from the region. India had followed a policy of import substitution and public sector domination since 1971, and remained entrenched in its inward orientation until 1991. There was therefore an ideological clash between a protectionist India and a rapidly-growing neoliberal Sri Lanka.

India's neighbourhood policy during the 1980s was described by a retired Sri Lankan diplomat (p.c.) as 'deplorable and reprehensible' and 'deeply entrenched in its India only policy'. Its realist stance was also manifested in economics. It was 'unwilling to be generous to its smaller neighbours, and Sri Lanka had a constant battle with the Indian authorities to protect the few concessions it had obtained via the Bangkok Agreement' (ibid.). He observed

a corresponding lack of interest on the Sri Lankan side in economic integration with India during this period.

India's aggression during this period extended not only to Sri Lanka, but towards all its South Asian neighbours. It undermined efforts made by smaller countries at regional integration via the formation of SAARC in 1985, whose realist rationale was to collectively counter and contain Indian hegemony in the region (Jorgensen 2001: 138; Bajpai 1999: 76). India viewed SAARC with suspicion and as an attempt by smaller countries to form a *cordon sanitaire* around it (Sri Lankan diplomats, p.c.). Historically, India's realist role undermined efforts towards good bilateral relations and regional integration in South Asia.

## 5.5 Economic Reform Process and Neoliberal Ascendancy

1991 marked a watershed in India's neighbourhood policy in general, and its policy towards Sri Lanka in particular. Two events marked this shift. The first was the assassination of India's former Prime Minister and then Opposition Leader Rajiv Gandhi by the LTTE, in southern India in May 1991. The second was the coming into office of the Congress(I)-led Rao government in June 1991, and inauguration of the economic reform process and the neoliberal project in India. The former ended India's overt intervention in Sri Lanka. The latter opened a new chapter in India's policy towards it via economic engagement. The convergence of economic policies and neoliberal ideologies in the two countries in the post-1991 phase provided significant impetus to this process.

There are some key features in India's neoliberal project that have a significant bearing on the transformation in India's neighbourhood policy. First, India was a late entrant to neoliberalism, which by 1991 had become the unchallenged orthodoxy globally. Second, by 1991, there was already a significant technocratic lobby within India that was supportive of deregulation and more market-friendly policies (Ghosh 1998: 322). This meant that the push for economic reforms in India was not entirely driven by international pressure, and largely emanated from within, driven by this elite neoliberal technocracy (Mooij 2005: 25). The partnership these elites had with neoliberal technocrats of Sri Lanka was an important driver of the ILA (Moragoda, Dhanapala, Casie Chetty, and Weerasinghe, p.c). Third, reforms in India were introduced gradually, and were influenced by political considerations, which meant that sensitive sectors remained protected (Mooij 2005: 22-23). Fourth, the reform process resonated well with India's larger vision of emerging as a global power, by securing energy security and connectivity within the neighbourhood and the world. Lastly, like in other developing countries, in India too neoliberalism established a strange mixture of authoritarian rule and clientelist politics (Mooij 2005: 30). There was also an increasing convergence between the reform process and emerging Hindu nationalism in India, which

coincided with the rapid rise to power in India of the BJP in the mid-1990s on a Hindu nationalist platform (Mooij 2005: 33-40).

This convergence led to the BJP's reinvention of the authoritarian state in India, via nuclearisation and a more assertive foreign policy on the one hand, and the recasting of India's hegemonic role via economic engagement on the other (Saeed 2004: 3-44; Mooij 2005: 33-34). The foundation to this emergent nationalism was set by the Congress-led Rao government which inaugurated neoliberal reforms, through the reconsolidation of India's nuclear and security programme, including increased military spending. There was a convergence of market and strategic interests in India's neoliberal project with its emergence in the 1990s as an economic power house.

Another factor which marked a radical shift in India's neighbourhood policy is the end of the cold. It extinguished India's key ally, the Soviet Union, and transformed India's relations with the US. In the post-1990 phase, India was no longer under cold war pressure to keep the US out of its sphere of influence, and there was an incremental convergence of interests between the two countries, as two democratic powers wedded to liberal economic principles (Saeed 2004: 30-34; Burns 2007). The convergence was also valued as a strategic counterweight to China and Pakistan (Gobarev 2000).

## **5.6 Post-1991 Period: India's New Neighbourhood Policy**

Although the neoliberal project in South Asia commenced with Sri Lanka in 1977, it was overall a slow process until India's liberalisation (Weerakoon and Thennakoon 2008: 135). With the latter, there was economic convergence and resulting neoliberal convergence within the region.

The Gujral doctrine spelt out in 1996 by India's Prime Minister I.K. Gujral, is a good indicator with which to trace the shift in India's neighbourhood policy in the post-1991 period. It is a set of five principles that define India's conduct towards its immediate neighbourhood. Its basis is acknowledgement of India's asymmetrical responsibility vis-à-vis its neighbours for mutual benefit, without expecting reciprocity, and its acknowledged leadership role in the region (Murthy 2000). The doctrine stands in opposition to the Indira doctrine which conceived the consolidation of India's power exclusively for self interest, and only through political means. According to Muni, India was 'a towering presence' in the region in the 1980s, and the Gujral doctrine helped break this mould (Rodrigo, p.c.).

The Gujral doctrine is reflected in India's economic policy vis-à-vis its neighbours in its neoliberal phase. For example, the principle of asymmetric responsibility and non-reciprocity is incorporated into the ILA, via the granting of asymmetrical and unilateral concessions to Sri Lanka. The principle is also



incorporated into India's provision of unilateral concessions to LDC neighbours, and into India's other bilateral agreements in the neighbourhood (Saran 2005; Annex 3[5-5]).

Many Sri Lankan and Indian officials/diplomats agree that the Gujral doctrine had a significant positive influence on the region, although it was translated into action later (Moragoda, Rodrigo, Casie Chetty, Kelegama and an Indian diplomat, p.c.). Sri Lanka's Foreign Minister Kadirgamar (1996, Annex 3[1-1]) unreservedly welcomed and endorsed the Gujral propositions and Prime Minister Manmohan Singh made frequent reference to India's 'asymmetrical responsibility' (Singh 2007; Annex 3[6-2]). This is evidence of its continuing validity to India's neighbourhood policy today.

But the Gujral doctrine was articulated in the mid-1990s when conditions were not yet ripe for its implementation. The ILA was therefore implemented at a time when India's neighbourhood policy was in its early phase of transformation and when its realist image was still dominant. This is evident from comments made by a retired Sri Lankan diplomat regarding the Sri Lankan bureaucracy's apprehensions regarding the ILA in 1998. He noted that, in December 1998 during President Kumaratunga's visit to New Delhi, the Sri Lankan delegation, with the exception of Jayawardena, was reluctant to sign the ILA, fearing India's intent due to the bitter experience of the 1980s. Murthy (1999) reiterates this threat perception, by asserting that 'opinions in Sri Lanka have also questioned the need for all the secrecy that was associated with conclusion' of the ILA, and 'questioned India's political agenda in rushing through this agreement'. India's strategic thinking vis-à-vis the ILA is illustrated by another Sri Lankan technocrat (p.c.) who notes that the proposal for an FTA which emanated from the Indian side in 1998, had the support of India's National Security Advisor Mishra, who consequently directed India's High Commissioner in Sri Lanka Menon, to translate the proposal into reality. India's message to Pakistan via the ILA was that it would forge bilateral ties with all its South Asian neighbours, except Pakistan (ibid.).

Implementation of the Gujral doctrine was to be seen later, in the 2004/2005 period, with Indian Foreign Secretary Saran's seminal speech of 2005 on India's neighbourhood policy which traced India's shift from 'threat' to 'opportunity' (Indian diplomat, p.c., Annex 3[5-4]). Saran (2005) observes that India's growing economic prosperity has led to greater self confidence, which has enabled India to be more generous today than in the mid-1990s. This assertion supports my analysis of the ILA in Chapter 4, where India's grant of unilateral and asymmetric concessions can be seen as an incremental process, coinciding with India's increasing economic prosperity and growing confidence in the market. India is also aware that these concessions will not harm its commercial interests (Sikri 2007: 6).

While all Sri Lankan diplomats agreed on the geopolitical motivations of India vis-à-vis Sri Lanka, not all agreed that India's neighbourhood policy had

changed significantly after 1991. There was a difference in the way functioning officials/diplomats and their retired counterparts viewed India's neighbourhood policy. The former group saw it changing, becoming more flexible/accommodative, while the latter group saw the continuation of realist intent in it. Officials of the Sri Lankan Commerce Department and functioning Sri Lankan diplomats (p.c.) saw India becoming increasingly generous in its conduct vis-à-vis neighbours today. They noted that it had been extremely protectionist during the initial phase of the ILA, but had become increasingly cooperative and willing to resolve problems to mutual satisfaction, with increasing concessions granted to Sri Lanka. A former Sri Lankan High Commissioner in India (1997-2004) observed that during his tenure, the 'good relations' between India and Sri Lanka were 'almost tangible' (Moonesinghe, p.c.). On the other hand, two retired diplomats (p.c.) who had served in Delhi during the 1980s/early-1990s, saw the Indian bureaucracy as 'difficult and inward looking'. One noted that it 'systematically eviscerated the best plans of its political masters' (retired diplomat, p.c.).

India's neighbourhood policy has changed, but its objective of regional dominance has not. It has expanded to incorporate its ambitions to become a global power. India's global ambitions are reflected via its nuclear policy and its vigorous campaign to win a permanent seat in the UN Security Council. The unprecedented civil nuclear agreement reflects American acceptance of India as an emergent global rather than a regional power. India no longer flexes its muscle to coerce its neighbours, it uses market forces instead. The modality is no longer the LTTE as a means of destabilising Sri Lanka, but the ILA which bestows economic benefits. But the end objective of consolidating India's influence in Sri Lanka and the region incorporates an even more expansive view of Indian hegemony today. The BJP's reinvention of a more authoritarian state on a Hindu nationalist platform, has consolidated a more assertive, realist neighbourhood policy for India, even while it has reorganised international relations around the market (Mooij 2005: 33-34). This new image is described by a Sri Lankan diplomat as 'an iron fist in a silk glove', and by another as 'a modified version of the Indira doctrine with a human face', given the coexistence of strategic and economic elements (p.c.). I call this confluence of realist and neoliberal elements in India's new neighbourhood policy 'geostrategic neoliberalism', as it is neoliberal ideology driven by geopolitical imperatives. Foreign policy speeches of Indian Foreign Minister Sinha (2003) and Foreign Secretary Saran (2005) illustrate this confluence by noting that India is willing to open up its markets to all its neighbours, and all it asks in return is that the neighbours 'remain sensitive' to India's security concerns (Annex 3[4-1], [5-5]).

India's offer of economic prosperity to its neighbours coexists with the consolidation of its power in the neighbourhood. The view that India's economic engagement with Sri Lanka has geostrategic objectives is reiterated by Bhasin (2004) and Hariharan (2006).

## 5.7 Shift from ‘Threat to Opportunity’: The ILA as a Benchmark of India’s New Neighbourhood Policy

Figure 2 illustrates the transformation of India’s neighbourhood policy towards Sri Lanka from a realist to more accommodative position, following the convergence of Indo-Lanka neoliberal projects, which gave rise to the ILA. The following section illustrates how the ILA is an instrument articulating India’s new neighbourhood policy.

### 5.7.1 *An Instrument of Peace and Stability*

With neoliberal ascendancy, India’s priorities have shifted from state to market, from local to global, from self interest to fostering mutual confidence and trust in the neighbourhood. If there is political instability in the neighbourhood, it could hamper India’s emergence as a global power. India therefore needs a peaceful neighbourhood, and the means of achieving this is through economic integration of this space (Indian diplomat, p.c.).

Two points are seminal to India’s new neighbourhood policy: (i) its need for a peaceful and prosperous periphery; and (ii) its need for a periphery that would seize the opportunity of benefitting from India’s prosperity. Prime Minister Manmohan Singh in 2008 spoke of India’s aim ‘to create virtuous cycles of growth’ in the region, and affirms that it stands ready to play its part in ‘a stable, vibrant and prosperous South Asia’ (Singh 2008, Annex 3[7-1]). The ILA is therefore an instrument of achieving a peaceful and prosperous periphery. Foreign Secretary Saran’s 2005 speech articulating India’s new neighbourhood policy notes the following:

*‘For our own sustained economic development and the welfare of our people we need a peaceful and tranquil periphery. We also believe that the establishment of a peaceful neighbourhood is integrally linked to economic development in our neighbouring countries, an objective that would be best served by India giving access to its neighbours to its huge and growing market.’* (Saran 2005, Annex 3[5-6])

Saran’s assertion fits in with comments made by Indian and Sri Lankan officials that India today has a renewed interest in trading with the neighbourhood even with little economic gain from it, and it has been granting increasing concessions to Sri Lanka under the ILA in successive rounds of consultations, even without reciprocity. Udagedara (p.c.) observes that in the last round of consultations, India offered Sri Lanka concessions in ‘a spirit of friendship’, even while the latter was not able to meet its demand of providing a tariff preference for its light vehicle imports. India’s renewed interest in South Asia is reflected in the work reallocation of its Department of Commerce, where a separate South Asia Division has been set up headed by an Additional Secretary, giving primacy to trade with neighbours (Kumar, p.c.). India today does not desire a decrease in Sri Lanka’s exports to India given its objective to see the island benefit from the ILA (Udagedara and Dharmapriya, p.c.). Indian diplomats handling the Sri Lanka brief actively encourage their

businessmen to export under the ILA (an Indian diplomat, p.c.). India's concessions to Sri Lanka are therefore largely driven by political imperatives given the relative insignificance of its market for India.

### ***5.7.2 A Model/Confidence-Building Instrument***

The ILA is marketed as a model instrument in the neighbourhood via the asymmetries built into it, which turns India into an opportunity for its (smaller) neighbours. Indian and Sri Lankan diplomats (p.c.) noted that India hoped to replicate its success both within the region and elsewhere. It enables India to project 'a benign image of itself to the neighbourhood and a magnanimous neighbourhood policy to the rest of the world' (a Sri Lankan diplomat, p.c.). India hoped that the economic dynamism and the more balanced bilateral trading relationship being created through the ILA would help take the focus away from 'other irritants', and consolidate relations around mutual benefit (ibid.).

Unlike India that did not need a preferential instrument to trade with its neighbours, smaller countries like Sri Lanka could not access the Indian market without one (Weerasinghe, p.c.). India therefore acknowledged its need to be generous and magnanimous in stimulating economic growth of its neighbours (Sikri 2007: 6). Indian diplomats (p.c.) emphasised that the ILA is 'a potential market for Sri Lanka, not for India'.

This projection of magnanimity by India has the geostrategic objective of consolidating neighbourhood stability. The ILA therefore enables India to project itself to the world as a benevolent regional hegemon that provides economic benefits and stability to Sri Lanka, and the neighbourhood, via a model relationship. The ILA gives increasing legitimacy to India as a credible regional power worthy of graduating to a global power.

### ***5.7.3 A Means of Consolidating India's Centrality***

India continues to acknowledge its centrality in the region while recasting its role as hegemon in a more benign light via bilateral engagement. While its new neighbourhood policy seeks integration with its friendlier neighbours, it continues to face a dilemma with archrival Pakistan. India wants to integrate with Pakistan as with its other South Asian neighbours but it also wants, simultaneously, to isolate it within the region. This ambiguity makes India continuously sceptical of the multilateral track of SAARC/SAPTA due to 'fear of side deals' (Indian and Sri Lankan diplomat, p.c.). Saran in his speech voices this fear of neighbours attempting to contain and countervail India, a fear that motivated India to postpone successive SAARC Summits in 1998/1999 and 2004/2005 (Saran 2005, Annex 3[5-1, 5-2]).

However, unlike in the pre-1991 phase, there is some evidence today to suggest that India increasingly wants the functionality of multilateralism in the neighbourhood, and would prefer to use both bilateral and multilateral tracks (both ILA and SAFTA), given its increasing need for connectivity and cross-border linkages within the neighbourhood. With the erosion of cold war concerns, and its improved relations with the US and China, India has now become 'slightly more confident' of the multilateral track, but continues to have an ambiguous approach to SAARC (Sri Lankan diplomat, p.c.). It would like SAARC to continue while keeping 'a watchful eye on it'. It now officially acknowledges its commitment towards SAARC/SAFTA, unlike the 1998-2004 period when it made little reference to SAARC vis-à-vis its foreign policy. This process is complemented by India's improved relations with its neighbours today except with Pakistan.

Establishing intra-SAARC physical connectivity, is a policy priority for India today (Sikri 2007: 7-9; an Indian diplomat, p.c.). The theme of the 14<sup>th</sup> SAARC Summit in New Delhi in 2007 was having better connectivity within South Asia. This is driven by India's need to gain transit facilities across Pakistan to Afghanistan and across Bangladesh to Northeast India. India's smaller neighbours have shown greater interest in integrating with India, unlike the bigger countries of Pakistan and Bangladesh (ibid.). But the cooperation of the latter is essential for India in establishing physical linkages with ASEAN, Central Asian and Middle Eastern markets and energy sources.

India therefore has good reason to seek multilateral integration within the neighbourhood, but given the persisting conflicts it veers towards an India-centric integration. The bilateral track remains dynamic and provides centrality to India. The ILA therefore continues to be positioned as an outcome of the failure of the multilateral track and India's scepticism of it.

#### ***5.7.4 A Means of Enhancing Indo-Lanka Strategic Space***

While all South Asian nations view India as a threat, they (except for Pakistan and to an extent Bangladesh) also see it as a guarantor of their security (Sikri 2007: 5). Sri Lanka too has in recent years followed the latter strategy aimed at increasing India's economic stakes in the island so that any security threats to Sri Lanka would be deemed a threat to India (Narayan Swamy 2007). This is a continuation of a uniform strategy of engaging India followed by successive Sri Lankan governments (of both main parties) since 1991. The strategy is to 'lock in' Indian investment and interests in Sri Lanka and overcome internal security vulnerabilities including threats to the Sri Lankan state. When the SLFP-led PA government assumed office in 1994, its interest in economic integration with India contained this strategic component. It saw a strategic advantage in signing the ILA, through which it hoped to engage India more directly in combating the LTTE. India had after its abortive attempt at peacekeeping in Sri Lanka in 1987-1990, and the Rajiv Gandhi assassination in 1991, retreated from playing a direct role in resolving the island's ethnic conflict and followed

a 'hands off' approach. Successive Sri Lankan governments, while fearing India's coercive power, simultaneously wanted it to be more directly involved in combating the LTTE. Foreign Minister Kadirgamar is on record stating that India is the only country that has 'a legitimate and permanent stake' in the resolution of Sri Lanka's conflict (Jayasekera 2003, Annex 3[2-1]). India however did have covert strategic cooperation with Sri Lanka in the post-1991 period. It maintained a close brief on the situation in Sri Lanka, and was closely associated with several abortive peace processes conducted by successive Sri Lankan governments. The extent of its support to the Sri Lankan government in combating the LTTE is however constrained by the dynamics of Tamil Nadu politics.

The best example of Sri Lanka's strategy of 'locking in' Indian interest for geopolitical advantage is the Wickremesinghe administration's leasing of the oil tank farms in eastern Sri Lanka, in strategically important Trincomalee, to Indian Oil Co. (IOC) in 2003. This US\$ 100 million Indian investment was partly driven by Sri Lanka's need to ensure energy security (Jayanetti and Jayawardhana (2004: 32). It was a political decision which gave India direct access to Sri Lanka's security and reflected Sri Lanka's tacit acceptance of India's status as the regional hegemon. Neoliberalism adopts investment as a new form of power projection (Balachandran, p.c.). According to Moragoda (p.c.) who played a key role in this project, the Wickremesinghe administration actively coveted this Indian investment in Trincomalee (see Annex 4). But contrary to popular perception, India was initially not interested, and India's National Security Advisor Mishra played a key role in persuading the Vajpayee government of its merit. The entry of India into Sri Lanka's petroleum market significantly changed the scenario for Indian imports and India today controls a significant portion of the island's energy requirements including petroleum distribution (Wickramasinghe 2007: 15; Dharmapriya, p.c.).

Sri Lankan diplomats (p.c.) acknowledged that the island needed to be 'strategic about economic integration with India', and physically 'lock in' Indian investment in Sri Lanka to overcome internal security vulnerabilities. As one diplomat (p.c.) observed, the IOC investment was 'a good way of obtaining an Indian economic stake in Trincomalee, which is vulnerable in terms of internal security and could well be the future capital of Eelam.

While coveting India, Sri Lanka simultaneously views it as a threat, as evidenced via the recent resistance to CEPA. As result, Sri Lanka has supplemented its strategy of locking in Indian engagement, with one of counterbalancing Indian power by engaging the two rival players in the region, Pakistan and China. For example, Sri Lanka's FTA with Pakistan is seen as a counter-balance to India, with little economic benefit (Sri Lankan technocrats and Weerakoon, p.c.). This balancing process is easy for Sri Lanka, given the competitive pressure applied by countries like China and Japan in economic cooperation in Sri Lanka. The need for Sri Lanka to diversify its geopolitical options was acknowledged by several Sri Lankan diplomats (p.c.). One

diplomat (p.c.) observed that it should follow a strategy of attracting more investment from northern and eastern India, to counterbalance southern Indian investment in the island and the connected Tamil Nadu affinities. Given the ILA's dynamism, some Sri Lankan Commerce Department officials (p.c.) spoke on the necessity of simultaneous engagement of India and China, and therefore the need to have an FTA with China.

On India's part, its cold war fears have been replaced by suspicion of the influence of China and Pakistan within the region, manifested via the latter's virtual encircling of India via special relations with smaller neighbours like Sri Lanka (Raman 2008; Sri Lankan diplomats, p.c.). India's intensified economic engagement of Sri Lanka, via instruments such as the ILA, is therefore partly driven by strategic intent to counterbalance the influence of China and Pakistan in Sri Lanka, and to secure Sri Lanka as an exclusive space for India's power projection (Sri Lankan diplomat, p.c.; Hariharan 2006).

## 5.8 Summary

This chapter traces the transformation of India's neighbourhood policy from realist to a more accommodative power, and the transformation of India from threat to opportunity, following the inauguration of India's neoliberal project in the post-1991 period. Its new neighbourhood policy, in the wake of its economic reform process, comprises neoliberal ideology driven by geopolitical imperatives, which I have termed 'geostrategic neoliberalism'. The convergence of economic policies in South Asia in the post-1991 period is crucial for the transformation of India's neighbourhood policy and its resultant bilateral relations with Sri Lanka.

India's new neighbourhood policy is driven by its superpower ambitions to seek peace and prosperity within its neighbourhood, via economic engagement and the granting of increasing concessions to its neighbours. This is manifested via the ILA, projected as a model for the region through which the centrality of India is maintained. India's objectives are complemented by the two countries' mutual desire to enhance their respective strategic spaces via economic integration and balancing of the influence of other powers. India's desire for stability and prosperity in the neighbourhood, triggered by its new neighbourhood policy of geostrategic neoliberalism, is therefore a compelling driver of the ILA.

## Chapter 6

### CONCLUSION

This research paper addresses the central question of how the dynamism of the ILA can be conceptualised, and what are its geopolitical drivers. In answering the question, I have first reviewed the existing literature on the ILA, and identified its economic and political drivers as presented in the literature. While the latter is divided on the ILA's effectiveness, most acknowledge its dynamism. While all existing studies have conceptualised the ILA from an economic perspective, most have briefly acknowledged that there are compelling geopolitical imperatives driving it. They identify a strong economic argument for Sri Lanka to have entered it, to gain from first-mover advantage to the then largely protected Indian market, and to continue to benefit thereafter via a substantial increase in its exports to India, and from an increase in Indian investment in Sri Lanka. However, given the very small size of Sri Lanka's economy, the ILA's benefit for India cannot be primarily economic. I therefore find the economic argument by itself to be an inadequate explanation of its dynamism, and argue that it needs to be complemented with a geopolitical argument. No comprehensive study has been undertaken examining the ILA from a geopolitical perspective.

My hypothesis was that in addition to economic imperatives, there may be compelling geopolitical factors driving the ILA, in the context of the transformation of India's neighbourhood policy following liberalisation. The conceptual framework I have adopted is an IPE approach from a state-centric realist perspective. I have examined the political economy of the ILA vis-à-vis the transformation of India's role from coercive/aggressive hegemon in its realist phase to enlightened/accommodative hegemon in its neoliberal phase. The conceptual framework has conceived India's neoliberal project as incorporating a convergence of the market and geopolitics.

There was a strong ideational drive emanating from Sri Lanka to integrate with the vast, growing Indian market economically, and this had political resonance with successive Sri Lankan governments in office when the ILA came into effect in 1998-2000, and when initial negotiations were underway to upgrade it to CEPA in 2002-2004. Projecting Sri Lanka via the ILA as a gateway to the Indian market and therefore an attractive investment destination became popular rhetoric with weak coalition governments in Sri Lanka that sought to consolidate their authority with their constituency using catchy economic slogans. Unlike India, Sri Lanka badly needed a preferential instrument to access the Indian market, given the massive bilateral trade imbalance. Successive Sri Lankan governments also used the ILA as a strategic instrument of economic integration with India to overcome internal threats to the Sri Lankan state, and seek shelter within the Indian security umbrella. But Sri Lanka also continued to fluctuate between the desire to integrate with India economically and benefit from India's economic prosperity and security



umbrella, and the fear of subjugation under India's political power and economic dominance. This fear led Sri Lanka to counterbalance India through engagement with China and Pakistan.

From an economic perspective, India benefitted little from the ILA, and its growing economy became increasingly focussed on free trade with the Asia Pacific region and the west. Nevertheless, the ILA received foreign policy attention at the highest level in India as an important dimension of the positive transformation of Indo-Lanka relations in its neoliberal phase. The immediate imperative for India's agreement to the ILA was realist and stemmed from its isolation following the India-Pakistan nuclear tests in May 1998. The latter led to an escalation of tension between the two countries. This motivated India to seek new friends and markets within the neighbourhood and to use the ILA to isolate Pakistan within the region.

There are many parallels in Indo-Lanka politics that provided impetus to the ILA. Both countries had coalition politics from the 1990s, which resulted in weak governments that were more vulnerable to concerns emanating from their respective constituencies. The ILA/CEPA process was influenced by the policies of the two main political parties in India, the BJP and the Congress; and in Sri Lanka, the PA and the UNP. The PA-UNP policy on India remained fairly consistent and both sought economic and strategic integration with it, even though the UNP remained more neoliberal. In India, the inauguration of the neoliberal project by the Congress-led government in 1991 resulted in the transformation of its neighbourhood policy from coercive to cooperative. The emergence of the BJP coalition in 1998 on a Hindu-nationalist platform with a more assertive foreign policy articulated India's desire to emerge as a global power, and provided a strong geopolitical imperative to its neoliberal project and neighbourhood policy. The ILA was a process largely driven by an elite group within each of these governments, with considerable input from neoliberal technocrats. The little involvement of the private sector in the process has been most visible at moments of resistance to trade liberalisation, such as the resistance by some Sri Lankan entrepreneurs to upgrading the ILA to CEPA, or the intermittent resistance by certain powerful local industrial lobbies in India to a surge in exports from Sri Lanka under the ILA. There has been no involvement of civil society of either country.

India's neighbourhood policy is historically defined by vast power asymmetries between India and its neighbours, as well as the Indo-centric nature of the region. The neoliberal project has recast India's role as regional hegemon in a more benign light, marking its transformation from threat to opportunity. Sri Lanka's neoliberal project in the late-1970s and 1980s contradicted India's autarkic economic policy during this period and resulted in tense bilateral relations between the two countries. India's military intervention in Sri Lanka in the 1980s was replaced in the 1990s with positive transformation of bilateral relations via the market. Economic convergence around the neoliberal project was a prerequisite for the normalisation of Indo-

Lanka relations in the 1990s and its transformation. It was also imperative for the ILA to take effect. Neoliberal India endorsed the principle of asymmetric responsibility, which was incorporated into the ILA via its provision of unilateral and asymmetric concessions to Sri Lanka as the smaller, more vulnerable economy. With India's growing self confidence in its economic potential from the late-1990s, its grant of unilateral and asymmetric concessions became an incremental process and was replicated vis-à-vis all its smaller neighbours and Bangladesh. This positive transformation of its neighbourhood policy via its new role as a more accommodative, enlightened hegemon is leading to an India-centric convergence of all countries in the neighbourhood, except Pakistan. The failure of the multilateral track in South Asia, historically due to India's fear of Pakistan, is now increasingly due to Pakistan's non-cooperation in the regional integration project. While its failure continues to provide impetus to the India-centric bilateral track, there is increasing evidence that India now desires the functionality of both bilateral and multilateral tracks. This is driven by its need for connectivity within the region to secure markets and energy resources. India increasingly views itself as an opportunity for the neighbourhood, and seeks its stability and prosperity, to realise the ambition of emerging as a global power in an increasingly multi-polar world. For India, the ILA is a means of achieving peace and prosperity in the periphery. Given the ILA's dynamism, India finds it an increasingly useful model for its neighbourhood policy, projecting its benevolence and magnanimity to the rest of the world.

India's neoliberal project that gave primacy to the market rather than military power, and rearranged its relations with its neighbours around the market, did not displace the state. It simultaneously co-opted the state in steering the country towards a more assertive nationalism and a global foreign policy, via its emergence as a nuclear power. India's neoliberal project has therefore brought about an unprecedented convergence of economic and strategic interests. The ILA-CEPA has, in this context, become a neoliberal instrument used by India to achieve a version of Indian hegemony in South Asia, that is more expansive than its pre-neoliberal, realist counterpart. It is now an India with global ambitions, which still does not want outside influence within its neighbourhood. What has changed for India is the means of attaining its objectives. Today it is not military aggression but the market. The end remains the same: the consolidation of India's power and influence in the neighbourhood. India's cold war fears of US intervention in the neighbourhood have been replaced in the post-1991 phase by its fears of Chinese and Pakistani influence, and the ILA is used by it as a strategic counterweight to these influences on Sri Lanka. I call this co-existence of neoliberal and realist elements in India's neighbourhood policy 'geostrategic neoliberalism', as it is neoliberalism pursued with geostrategic intent.

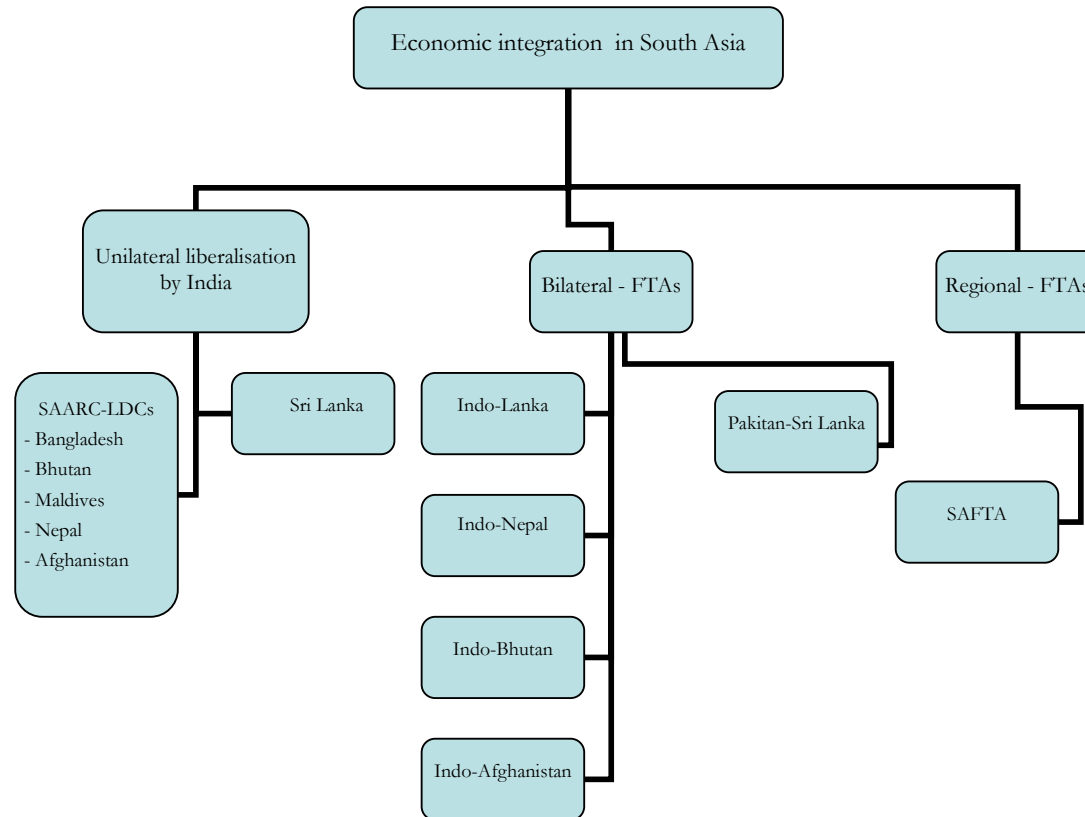
In addition to economic imperatives, India's new neighbourhood policy of geostrategic neoliberalism is a compelling driver of the ILA. I qualify this conclusion by acknowledging that it took place against the backdrop of a correspondingly strong interest on the part of successive Sri Lankan

governments to integrate with the Indian market for economic and strategic reasons, and the mutual desire of both India and Sri Lanka to enhance their respective geostrategic space through the market via the ILA.

It is likely that this India-centric convergence in the neighbourhood will in the future evolve into a pattern of greater cooperation between India and its smaller neighbours, and also expand to include bigger neighbours like Bangladesh, despite the continuation of intra-regional conflicts. It will nevertheless continue to exclude Pakistan until Indo-Pakistan relations get redefined in a more sustainable manner. Despite the continued exclusion of Pakistan and lack of regional integration, Sri Lanka stands to benefit both politically and economically from this evolving pattern of Indo-centric convergence and its changing bilateral relations. It will benefit from India's growing economic prosperity and deepened integration through the ILA/CEPA, while it continues to remain within India's sphere of influence. The resistance to CEPA in Sri Lanka is a replication of a previous pattern of the country's fluctuation between desire to integrate with India and its fear of it. It is therefore likely that the CEPA would be eventually signed. On the other hand, India will continue to show a consistent interest in deepening economic integration with Sri Lanka in the future. Resistance posed by its domestic lobbies and the Tamil Nadu factor can only be intermittent interludes in this process, and is unlikely to seriously derail India's evolving policy towards Sri Lanka.

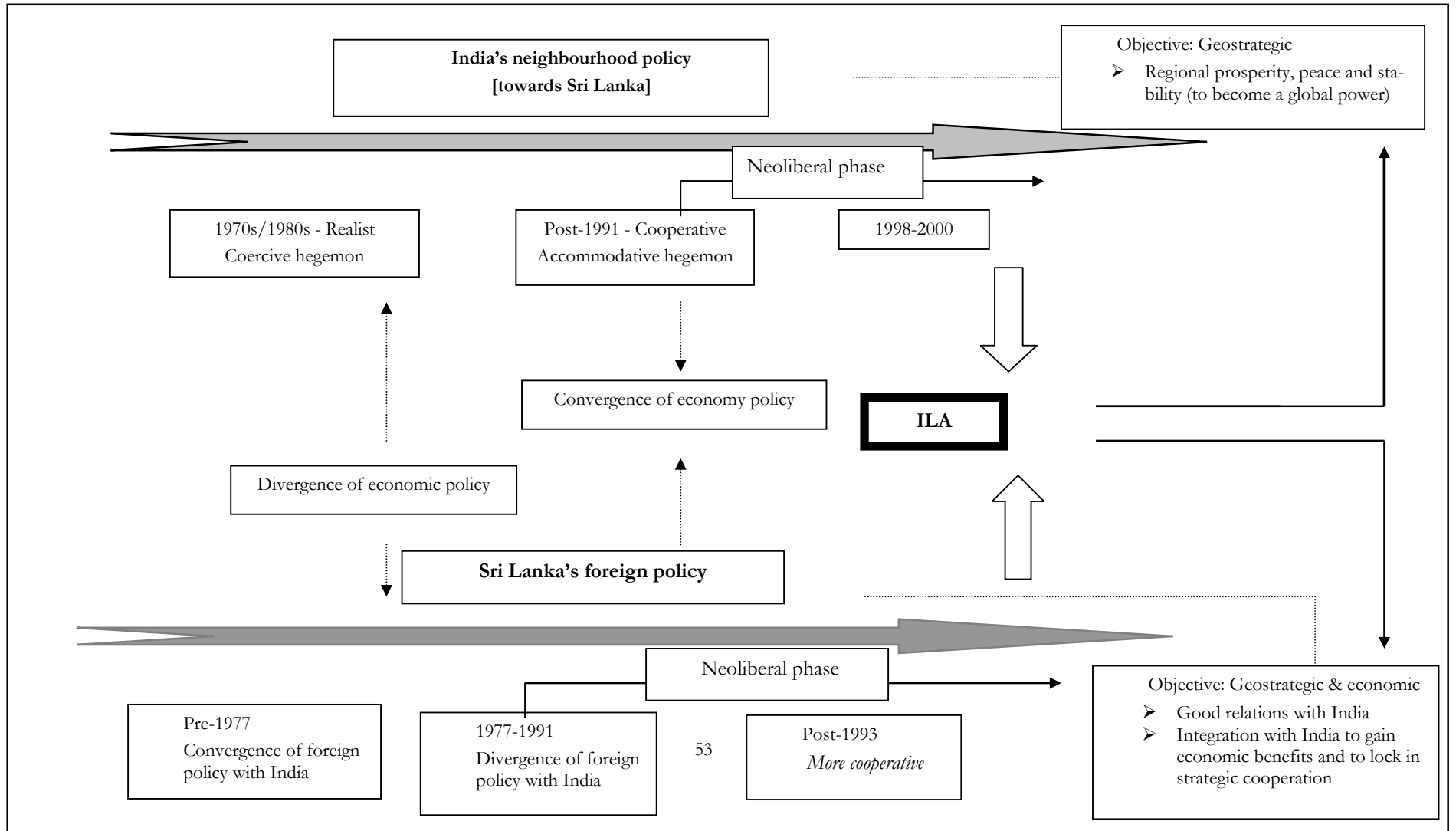
**Figure 1**

India-Centric Convergence: Trend in Economic Integration in South Asia



Source: Kelegama (2002: 179), with modifications.

**Figure 2**  
Transformation of India's Neighbourhood Policy



## Annex 1

### List of Interviews Conducted

Sri Lankan side:

	Category	Name	Designation	Date of Interview (2008)
1.	Politician (Cabinet Minister)	Mr. Milinda Moragoda	Minister of Tourism, and former Minister of Industries, Science and Technology in the Wickremesinghe Cabinet (2001-2004)	8 <sup>th</sup> August
2.	Ministry of Finance and Planning	Dr. P.B. Jayasundera	Former Secretary/Finance	11 <sup>th</sup> August
3.	Department of Commerce (current)	Mr. Gomi Senadheera	Director-General/Commerce	24 <sup>th</sup> July
4.		Mr. Saman Udagedara	Director	6 <sup>th</sup> August
5.		Mr. D.G.A.P. Dharmapriya	Deputy Director	6 <sup>th</sup> August
6.	Department of Commerce (retired)	Mr. K.J. Weerasinghe	Former Director-General/Commerce	29 <sup>th</sup> July
7.	Ministry of Foreign Affairs (current)	Dr. Palitha Kohona	Secretary/Foreign Affairs	15 <sup>th</sup> July
8.		Mr. Romesh Jayasinghe	High Commissioner of Sri Lanka in New Delhi	4 <sup>th</sup> August
9.		Mr. Ravinatha Aryasinha	Ambassador of Sri Lanka to the European Communities in Brussels	30 <sup>th</sup> August
10.	Ministry of Foreign Affairs (retired)	Mr. Jayantha Dhanapala	Former UN Undersecretary-General, former High Commissioner of Sri Lanka in Washington and former Deputy High Commissioner of Sri Lanka in New Delhi	30 <sup>th</sup> July
11.		Nihal Rodrigo	Advisor (Foreign Relations) to the President Former Secretary General/SAARC, and former Additional Secretary/Foreign Affairs	1 <sup>st</sup> August
12.		Mr. H.M.G.S. Palihakkara	Former Secretary/Foreign Affairs, and currently Sri Lanka's Ambassador to the United Nations in New York	27 <sup>th</sup> July
13.		Mr. C.D. Casie Chetty	Former Additional Secretary/Foreign Affairs, former Director-General/Economic Affairs and former Deputy High Commissioner of Sri Lanka in New Delhi	4 <sup>th</sup> August
14.		Mr. Nanda Godage	Former Additional Secretary/Foreign	23 <sup>rd</sup> July &

			Affairs and former Deputy High Commissioner of Sri Lanka in New Delhi	31 <sup>st</sup> July
15.	Diplomats (Non-career/Retired)	Mr. Mangala Moonesinghe	Former High Commissioner of Sri Lanka in New Delhi	25 <sup>th</sup> July
16.	Institute of Policy Studies (Economists)	Dr. Saman Kelegama	Executive Director	5 <sup>th</sup> August
17.		Dr. Dushini Weerakoon	Deputy Director and Fellow	4 <sup>th</sup> July
18.		Mr. Janaka Wijayasiri	Research Officer	15 <sup>th</sup> July
19.		Mr. Deshal de Mel	Research Officer	30 <sup>th</sup> July
20.	Private Sector (Ceylon Chamber of Commerce)	Ms. Ayoni Waniganayake	Senior Assistant Secretary-General	21 <sup>st</sup> July
21.		Ms. Subhashini Abeysinghe	Economist	21 <sup>st</sup> July
22.	Academics	Dr. Prema-chandra Athukorala	Professor of Economics, Australian National University	31 <sup>st</sup> August
23.		Dr. Sisira Jayasuriya	Associate Professor, University of Melbourne	10 <sup>th</sup> September

Indian side:

	Category	Name	Designation	Date of Interview (2008)
1.	Ministry of External Affairs	- (Withheld)	Diplomat (Withheld)	18 <sup>th</sup> July
2.		- (Withheld)	Diplomat (Withheld)	8 <sup>th</sup> September
3.	Department of Commerce	Mr. Rajiv Kumar	Director	11 <sup>th</sup> July
4.	Private sector	Mr. Oscar Braganza	Managing Director and CEO, CEAT-Kelani Associated Holdings (Pvt.) Ltd.	10 <sup>th</sup> July
5.		Mr. Prem Kumar Thampi	Country Head/Sri Lanka, ICICI Bank	22 <sup>nd</sup> July
6.	Media	Mr. P.K. Balachandran	Indian journalist based in Colombo, and former Special Correspondent of the Hindustan Times	18 <sup>th</sup> July

## Annex 2

### Impact of the ILA

Following the implementation of the ILA, the period 2000-2005 saw a surge in two-way trade between India and Sri Lanka (Kelegama and Mukherji 2007: 05). Sri Lanka's exports to India rose from 1 percent to 9 percent of total exports, while imports from India increased from 8.5 percent to 20.7 percent of total imports. By 2005, 90 percent of Sri Lankan exports to India and 45 percent of Indian exports to Sri Lanka came under the ILA. Sri Lanka's import-to-export ratio fell from 10.3:1 to 3.3:1. There was a visible shift in Sri Lanka's exports from agricultural products to manufacturing goods. India today ranks as the third largest export destination for Sri Lanka, rising from 16<sup>th</sup> rank in 2000. A number of Sri Lankan firms producing both industrial and consumer goods successfully entered the Indian market within the framework of the ILA.

India's trade with Sri Lanka also increased overwhelmingly during this period (Wickramasinghe 2007: 16). But this cannot be solely attributed to the ILA. The main Indian exports to Sri Lanka comprising automobiles/transport items, mineral fuels/oils, cotton, iron and steel, machinery, mechanical appliances and pharmaceuticals were high-revenue-generating products for Sri Lanka and were placed under its negative list. More than 50 percent of imports from India to Sri Lanka therefore do not come under the ILA. Even so, imports from India continued to increase, and today India ranks as the largest source of imports to Sri Lanka.

The ILA also led to a significant increase in Indian investment in Sri Lanka. The cumulative Indian investment by 1998 was only Rs. 165 million, which jumped to Rs. 1,515 million in 2000 and continued to rise yearly thereafter (Wickramasinghe 2007: 16). Since 2005, Over 50 percent of Indian investment (joint ventures and wholly owned subsidiaries) in South Asia came to be located in Sri Lanka, and India is now its fifth largest investor. Indian investment projects had a positive impact on exports from Sri Lanka, and the domestic value addition indicated an increasing trend over the years (Wickramasinghe 2007: 24). The ILA provided impetus to Indian companies to set up joint ventures in Sri Lanka with a view to buy back for the duty free Indian market, particularly in South India. Among these, vanaspati, copper, bakery shortening/margarine and marble industries are prominent.

But according to disaggregated trade and investment data, the real impact of the ILA is far less impressive than that portrayed by the aggregate data (Baysan et al. 2006: 4-7; De Mel 2008: 13). The main Sri Lankan exports to India are copper and copper products, vanaspati and aluminium, spices, electrical machinery and equipment. A large proportion of these are intermediate products required for the Indian industry, many with low value

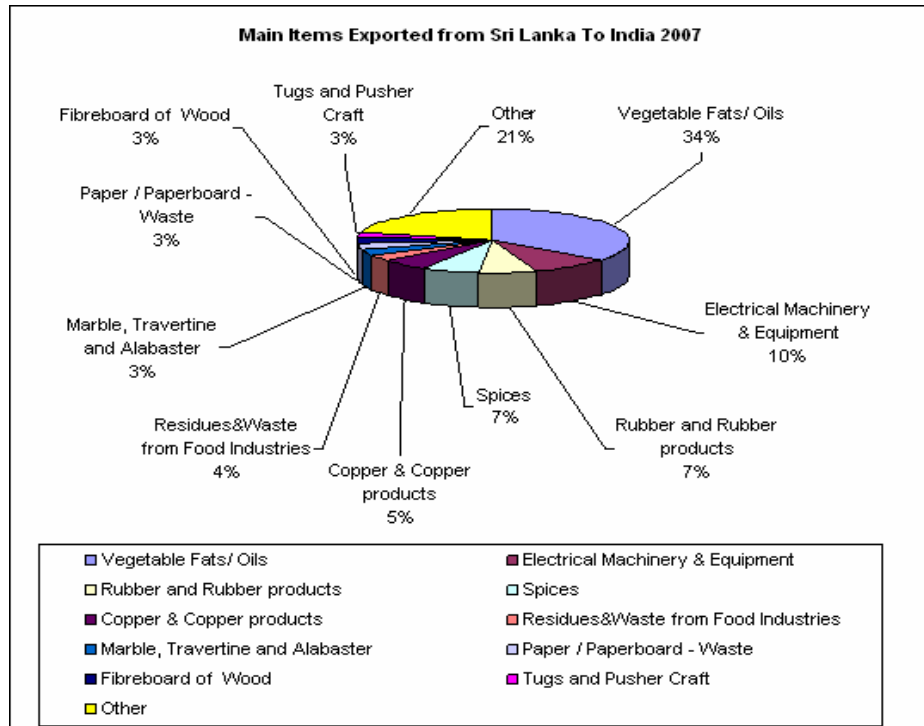


addition (Kelegama 2003). Sri Lanka is showing an increasing trend of emerging as a processing centre for intermediate goods needed for manufacturing industries in India.

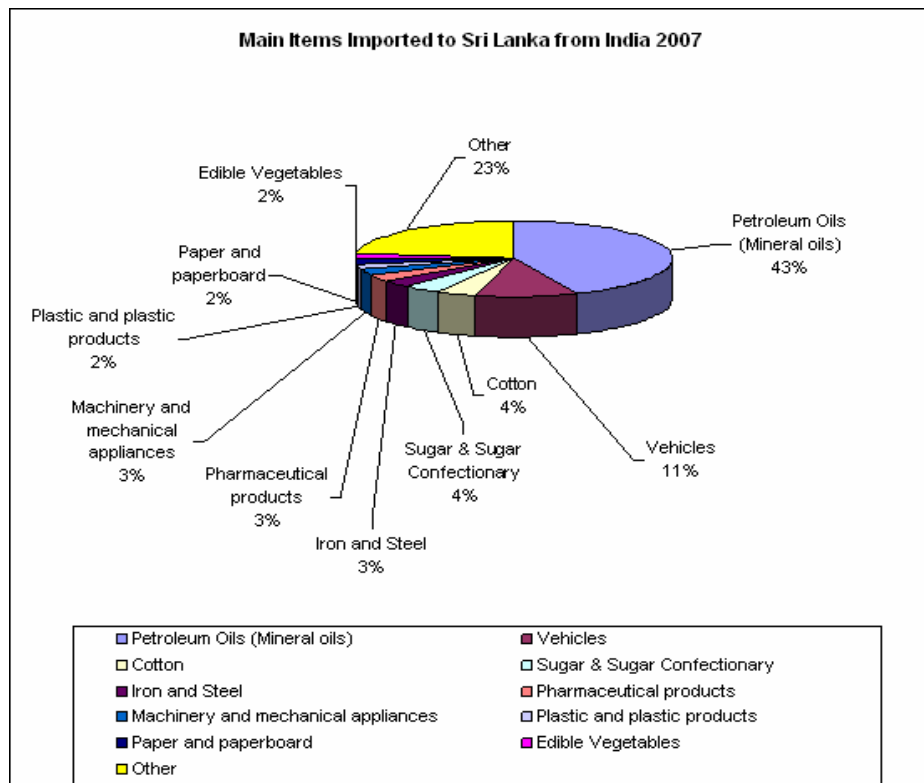
Additionally, Sri Lanka's major exports to India and to the world are subjected to a tariff rate quota or a negative-list exception by India (Baysan et al. 2006: 04-07). Both tea and garments, Sri Lanka's two top exports, are restricted via ROO requirements, and subject to the uniquely South Asian rules of destination restriction, which is that products should enter India only through specific Indian ports. The countervailing measures thus introduced by India have led to a decrease in Sri Lanka's major exports to India since 2005. Sri Lanka, on the contrary, has adhered to the spirit of the ILA and not imposed any NTBs/TRQs despite pressure from certain local small- and medium- enterprises to do so (Tudugala 2008). It is of the view that the imposition of these 'safeguards' by the Indian government go against the spirit of the ILA, and have diluted the SDT privileges offered to Sri Lanka via the ILA, and thereby prevented a more positive impact from it (De Mel 2008: 13; Kelegama 2008: 09; Kelegama and Mukherji 2007: 23).

While Sri Lanka is not a significant market for India, it does not mean that Indian business did not benefit from it. Indian business continues to find the Sri Lankan market lucrative, in areas such as vehicle exports, and as a stepping stone to penetrating the Southeast Asian market (Indian diplomats, p.c.). For example, over 50 percent of Tata vehicles were exported to Sri Lanka, and India's exports to Bangladesh and Sri Lanka in most years surpassed its exports to South Korea and all ASEAN nations except Singapore (Wickramasinghe 2007: 11-13).

Bilateral trade between India and Sri Lanka crossed the US \$ 3 billion mark in 2007. The ILA has expanded two-way trade between India and Sri Lanka, changed the volume of exports from Sri Lanka to India as well as its composition, and increased Indian investment in Sri Lanka (Wickramasinghe 2007: 15). Although the volume and composition of imports from India to Sri Lanka have also changed, this cannot be attributed to the ILA. This shows that Sri Lanka continues to need the ILA more than India to access the Indian market.



Source : Indian High Commission in Sri Lanka, 7 November 2008.



Source: Indian High Commission in Sri Lanka, 7 November 2008.

### Annex 3

#### Excerpts from Sri Lankan and Indian Foreign Policy Speeches/Interviews with Reference to India's New Neighbourhood Policy

I have organised the excerpts from earliest to the most recent, in order to project the evolution of India's new neighbourhood policy as an incremental project.

- (1) Sri Lanka's Foreign Minister Lakshman Kadirgamar's speech on 'Regional Cooperation and Security: A Sri Lankan View' in Rajasthan in December 1996

(1-1) Welcoming the five precepts of Prime Minister I.K. Gujral, which subsequently came to be known as the 'Gujral doctrine':

*'Each of these five propositions is intrinsically sound. Each is wise. Each is capable of implementation. Taken collectively, they constitute a practical and principled foundation for regional cooperation and security. I endorse them without reservation and I express the hope, the fervent hope of all of us in the other five countries of the region, that India and Pakistan will see in these principles the way forward for them on the path of friendship and peace.'*

- (2) Sri Lanka's Ex-Foreign Minister Lakshman Kadirgamar in an Interview in March 2003 (Jayasekera 2003)

(2-1) Reference to the intrinsic linkage of Indo-Lanka geostrategic issues which bestows a special status to India in the neighbourhood:

*'In the final analysis India is the only country that counts as far as a solution to Sri Lanka's problem is concerned. It is the only country which has a legitimate and permanent stake in the destiny of Sri Lanka. ... The solution ultimately has to be worked out by the people of our country, and India will always have a legitimate interest and concern in what happens here. We must never lose sight of the geo-political realities of Sri Lanka's location in the South Asian region.'*

- (3) India's Foreign Minister Yashwant Sinha's Speech on 'Future Directions of India's Foreign Policy' in London in October 2002

(3-1) Reference to India's nuclearisation as having enhanced its strategic space:

*'My government believes that the overt exercise of the nuclear option by India has helped remove potentially dangerous strategic ambiguities in the region. It has enhanced the strategic space of the country and granted to it the needed autonomy.'*

(3-2) Reference to the neighbourhood as the first circle of India's foreign policy:

*'Let me turn now to the first circle of our foreign policy, that of our immediate neighbourhood. India has always sought to maintain good and friendly relations with all its neighbours and we do have excellent relations with all - except Pakistan, which has uniformly repaid our peaceful overtures with hostility. The issue here is very clear. We want a peaceful, a prosperous and a stable Pakistan.'*

(4) India's Foreign Minister Yashwant Sinha's Speech on 'India's Foreign Policy Today' in Moscow in February 2003

(4-1) Reference to India's willingness to cooperate with neighbours conditional to consolidation of its influence in the neighbourhood:

*'India is willing to go to any length to improve relations with her immediate neighbours. All she asks in return is that they respect and remain sensitive to her security concerns'* (Sinha 2003).

(4-2) Reference to India's increasing economic confidence impacting its foreign policy:

*'India today faces the future and the world with confidence and optimism. ... this self-assurance and a sense of achievement also permeate India's foreign policy.'*

(4-3) Reference to difficulties in pursuing the multilateral track due to Pakistan:

*'It is a matter of disappointment that despite having come formally into existence 17 years ago, SAARC is still to make progress with regard to its primary objective of economic cooperation between its members. Pakistan denies India even the most elementary MFN treatment.'*

*'As many of you would be aware, the biggest challenge to relations in India's neighbourhood comes from Pakistan which has persistently refused to shed its compulsive hostility.'*

(5) India's Foreign Secretary Shyam Saran's Speech on 'India and its Neighbours' in New Delhi in February 2005

(5-1) Reference to India's fear of SAARC/the multilateral track, being used as an instrument to counter Indian dominance:

*'India would not like to see a SAARC in which some of its members perceive it as a vehicle primarily to countervail India or to seek to limit its room for manoeuvre. .... .. if the thrust of initiatives of some of the members is seen to be patently hostile to India or motivated by a desire to contain India in some way, SAARC would continue to lack substance and energy.'*

(5-2) Reference to India's bilateral engagement in the neighbourhood:

*‘India already has a set of bilateral relationships with its neighbours, which vary in both political and economic intensity. What can SAARC offer as an additionality to this set of relationships?’*

(5-3) Reference to the need to have intra-regional physical connectivity:

*‘But the mere lowering of tariffs and pruning of negative lists do not add up to a true free market. The political lines dividing South Asia have also severed the transport and communication linkages among member countries. The road, rail and waterway links that bound the different sub-regions of the sub-continent into a vast interconnected web of economic and commercial links, still remain severed. Transit routes, which would have created mutual dependencies and mutual benefit, have fallen prey to narrow political calculations. Unless we are ready to restore these cross-border linkages and transportation arteries throughout our region, SAFTA would remain a limping shadow of its true potential.’*

(5-4) Reference of India’s shift from threat to opportunity with its growing economic prosperity:

*‘India is today one of the most dynamic and fastest growing economies of the world. .. Countries across the globe are beginning to see India as an indispensable economic partner and seeking mutually rewarding economic and commercial links with our emerging economy. Should not our neighbours also seek to share in the prospects for mutual prosperity India offers to them? Do countries in our neighbourhood envisage their own security and development in cooperation with India or in hostility to India or by seeking to isolate themselves from India against the logic of our geography? Some neighbours have taken advantage of India’s strengths and are reaping both economic and political benefits as a result. Others are not.’*

*‘The challenge for our diplomacy lies in convincing our neighbours that India is an opportunity not a threat, that far from being besieged by India, they have a vast, productive hinterland that would give their economies far greater opportunities for growth than if they were to rely on their domestic markets alone.’*

(5-5) Reference to India’s acceptance of asymmetrical responsibility along with consolidation of India’s influence in the neighbourhood:

*‘In the free markets that India has already established with Sri Lanka, Nepal and Bhutan, it has already accepted the principle of non-reciprocity. We are prepared to do more to throw open our markets to all our neighbours. We are prepared to invest our capital in rebuilding and upgrading cross-border infrastructure with each one of them. In a word, we are prepared to make our neighbours full stakeholders in India’s economic destiny and, through such cooperation, in creating a truly vibrant and globally competitive South Asian Economic Community.’*

*‘However, while we are ready and willing to accept this regional economic partnership and open up our markets to all our neighbours, we do expect that they demonstrate sensitivity to our vital concerns. These vital concerns relate to allowing the use of their territories for cross-border terrorism and hostile activity against India, for example, by*

*insurgent and secessionist groups. ... India cannot and will not ignore such conduct and will take whatever steps are necessary to safeguard its interests.'*

(5-6) Reference to neighbourhood stability in prosperity through economic integration with India:

*'For our own sustained economic development and the welfare of our people we need a peaceful and tranquil periphery. We also believe that the establishment of a peaceful neighbourhood is integrally linked to economic development in our neighbouring countries, an objective that would be best served by India giving access to its neighbours to its huge and growing market. Economic integration in the sub-continent must restore the natural flow of goods, peoples and ideas that characterized our shared space as South Asians, and which now stands interrupted due to political divisions.'*

(6) India's Prime Minister Manmohan Singh's Address at the 14<sup>th</sup> SAARC Summit in New Delhi in April 2007

(6-1) Emphasis on the need to have intra-regional connectivity:

*'Connectivity -- physical, economic and of the mind, enabling us to use fully our geographical and resource endowments, has historically been the key to our region's peace and prosperity. South Asia has flourished most when connected to itself and the rest of the world.'*

(6-2) Reference to India's acceptance of asymmetrical responsibility to achieve regional integration:

*'There is an ongoing process of building an open and integrated market from the Himalayas to the Pacific, covering a vast and dynamic economic region. SAFTA could have a major role to play in this new emerging architecture. India is ready to accept asymmetrical responsibilities, opening her markets to her South Asian neighbours without insisting on reciprocity. I am happy to announce today that we will allow duty free access to India before the end of this year to our South Asian neighbours who are Least Developed Countries and further reduce the sensitive list in respect of these countries.'*

(7) India's Prime Minister Manmohan Singh's Address at the 15<sup>th</sup> SAARC Summit in Colombo in August 2008

(7-1) Reference to neighbourhood stability in prosperity through economic integration with India:

*'Our aim should be to create virtuous cycles of growth in our region. A prosperous South Asia will also be a peaceful and stable South Asia.'*

*'India stands ready to play her part in the evolution of a stable, vibrant, and prosperous South Asia.'*

## Annex 4

### Lease of the Oil Tank Farm in Trincomalee to Indian Oil Co.

#### Background Information:

The oil tank farm in Trincomalee was leased to India's oil major, Indian Oil Co. (IOC) by the Sri Lankan government in 2003. This inaugurated IOC's operations in Sri Lanka's petroleum retail market through its wholly-owned subsidiary, Lanka IOC Pvt. Ltd. (LIOC). Under the MOU, a chain of 250 state-owned petroleum retail outlets in Sri Lanka were divested in favour of LIOC, to provide additional retailing services after modernisation. It is one of the largest Indian investments in Sri Lanka, and rates among the island's top 10 foreign investments.

The presence of US interests in Trincomalee during the cold war was a constant irritant and a source of concern to India and its ally the Soviet Union. This discontent contributed to India's intervention in Sri Lanka's internal conflict in the post-1977 period. But with shifting geopolitics after the cold war and advancement in military technology, the strategic importance of Trincomalee has waned from a global context, but not from a regional perspective, given the LTTE's claim to the region as part of its separate state of Tamil Eelam.

#### Excerpt from an Interview with Hon. Milinda Moragoda, Minister of Economic Reform, Science and Technology in the Wickremesinghe Cabinet (December 2001 to March 2004):

*'We [the Wickremesinghe regime] saw the lease of the oil tank farm in Trincomalee to a subsidiary of IOC as a means of creating a safety net for Sri Lanka's peace process, which in 2002-2003 was gaining momentum. To give India a major economic stake in eastern Sri Lanka was seen by us as a strategic move. Through this we gained an Indian presence in Trincomalee, which we saw as part of an international safety net against threats posed to the Sri Lankan state by the LTTE. Through this we also gained a large Indian investment in Sri Lanka's petroleum sector, and also the largest Indian investment in the island.*

*We discussed the oil tank lease proposal with Indian Foreign Minister Yashwant Sinha who supported the idea. Prime Minister Vajpayee was also supportive. But I should add that initially, India was not very interested in the proposal. It did not immediately perceive a major economic stake for itself. So we had to develop a brand new business model to make it more lucrative for IOC to invest in Sri Lanka's oil sector, by divesting 100 state-owned retail outlets to facilitate LIOC's entry into Sri Lanka's retail sector. This business model also enabled us to modernise the city of Colombo and suburbs, by LIOC's refurbishing and upgrading of existing retail outlets. The Sri Lanka government also agreed to pay a subsidy to LIOC under the MOU.*

*India's National Security Advisor Brajesh Mishra was very supportive of the proposal and played a pivotal role in persuading the Indian government to agree to it.*

*In my view the LIOC investment was initiated by the Sri Lankan government, and the Indian government reciprocated positively.*

*The LIOC investment served four purposes for Sri Lanka:*

- 1. A major Indian investment coming into Trincomalee sent a clear signal to the world and to the LTTE that India had a stake in this region.*
- 2. It fulfilled a condition of the 1987 Indo-Lanka Accord. Under the Accord, the governments of India and Sri Lanka agreed that the restoration and operation of the oil tank farm in Trincomalee would be undertaken as a joint venture.*
- 3. One of the major players in the Indian oil industry investing in Sri Lanka helped integrate our economy with India's.*
- 4. It enabled the deregulation of Sri Lanka's petroleum sector and opened it up for competition, even though it was a government-to-government venture.*



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## End Notes

<sup>1</sup> My interviews with Sri Lankan and Indian sources are hereafter referred to as 'p.c.' (personal communication/s). Annex 1 presents the list of sources with dates of interviews.

<sup>2</sup> The ILA was notified to WTO under the Enabling Clause (1979) and not under Article XXIV of GATT, because both countries did not desire a classic RTA covering 'substantially all trade' (meaning at least 85 percent of all trade), but an instrument with greater flexibility for the protection of sensitive sectors (Weerasinghe, p.c.).

<sup>3</sup> The asymmetry in the bilateral trade relationship is reflected in that exports to Sri Lanka constitute 2 percent of India's total exports to the world, which is equivalent to 20 percent of Sri Lanka's imports (Wickramasinghe 2007: 09). Conversely, Sri Lanka's exports to India constitute 8.9 percent of its total exports, which is a mere 0.4 percent of India's total imports (*ibid.*).

<sup>4</sup> But India's 'generosity' did not extend to all sectors. While Sri Lanka has a competitive advantage in aviation and wanted it scheduled in the CEPA, India objected, and wanted to discuss it bilaterally, based on the argument that aviation is not included in the GATS. Sri Lanka conversely argued that the CEPA should be 'GATS plus' (Kelegama and Wijayasiri, p.c.).