

Impact of the India-Sri Lanka Free Trade Agreement on India's Trade Intensity with Sri Lanka

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Abstract

India and Sri Lanka have engaged in a bilateral trade relationship since the colonial period. India has historically been one of Sri Lanka's key trading partners; with ISFTA (India-Sri Lanka Free Trade Agreement) in force in 2000 bilateral trade took a new-fangled route. The objective of the current study is to analyze and comprehend the trade patterns post ISFTA for 2002 to 2022 using the Export and Import Intensity Index. It is observed that India has relatively higher export and import intensity than Sri Lanka. So far, India's Export and Import Intensity Index with Sri Lanka has been reasonably consistent but declining, revealing great scope for India to expand its export/import magnitude to Sri Lanka making it larger than the latter's comparative demand from the world/relative supply to world. The results serve to strengthen both the countries' economic ties.

Keywords: Free Trade Agreement, ISFTA, Bilateral Trade, Export Intensity Index, Import Intensity Index.

Introduction:

India and Sri Lanka, the closest neighbors of the South Asia region have been sharing a congenial relationship in every sense, since the colonial period. In recent times, India-Lanka relations have become multi-faceted in trade, investment, development, and regional cooperation. Sri Lanka is not that important trade partner for India but the reverse is not true. India is a significant investor in Sri Lanka. India has traditionally been one of Sri Lanka's biggest trading partners. India covers well over 60% of Sri Lankan exports, and is the third biggest export market, after the United States and the United Kingdom. India was Sri Lanka's second major trading associate in 2020, with a reciprocal merchandise trade of around USD 3.6 billion.

India-Sri Lanka has a thriving and expanding trade and business relationship that has grown significantly over the years. Since 2000, the conclusion of the India-Sri Lanka free trade agreement (ISFTA), based on the "negative list" approach both countries embarked upon widening

the country's economic space and bringing in the benefits of economies of scale. The conjoint trade endeavor of both countries deepens the economic cooperation by following their growth strategies. Both achieved economic laurels by maximizing the welfare of nations. Both continue to be one of the leading SAARC trade partners. Sri Lanka India's active and largest trade partner accounted for 18.72 percent of the country's total SAARC export in 2019.

The trade relationship between India and Sri Lanka has gained a fresh acceleration in the economic growth of countries. The bilateral trade between the two countries has shown prodigious growth and yet there is ample untapped future trade potential. In the last decades, India has emerged as a global player and Sri Lanka as a competitive and resilient country. Consequently, in this paper, an attempt has been made to examine the intensity of trade and trade potential between India and Sri Lanka post ISFTA.

Literature Review:

Various available literature highlighted the India-Sri Lanka bilateral trade relationship. The study mainly concerned with economic cooperation between India and Sri Lanka, highlighted the scope for expanded cooperation for goods, investments, and services, suggesting pruning the negative lists, identifying potential investments, and suggesting policies for enhancing cooperation in services [1]. Since the operationalization of the India-Sri Lanka Free Trade Agreement (ISFTA) in 2000, both countries have shared vigorous economic and commercial partnerships in terms of growing trade and investment. The ISFTA covers trade in goods only and provides duty-free access or duty preferences for products except for negative list goods. This paper attempts to analyze the impact of ILFTA on liberalized trade between India and Sri Lanka and also the implications of extending the free trade agreement to other SAARC countries, by performing a simulation using a global trade analysis project (GTAP). Results reveal that both India and Sri Lanka enjoy welfare gains by signing the ILFTA. [2] The fixed effect model has been used for the period 1996 to 2006 to investigate the trade creation and trade diversion effects of India Sri Lanka Free Trade Agreement (ISLFTA). Results revealed that in control countries ISLFTA has a small trade creation effect [3]. As

an extension over ISFTA, the Economic and Technical Cooperation Agreement (ETCA) is being negotiated between India and Sri Lanka to widen the scope of trade, investment, and technological cooperation. With the imposition of ETCA, Sri Lanka became the main part of the Indian supply chain. This agreement paved the way for Indian professional, semi-skilled, and unskilled persons to set foot in the Sri Lankan labour market.

The authors analyzed trade dynamics, tariff structure, and investment scenarios between India and Sri Lanka. This study reveals that India is among the four largest overall investors in Sri Lanka. This study also mentioned that India and Sri Lanka enjoy comparative advantages in labor and resource-intensive sectors [4]. Here, discusses current trends, prospects, and trade and investment ties between India and Sri Lanka. It suggested the potential commodities and strategies for enhancing bilateral trade with Sri Lanka [5]. Moreover, the introduction of the SAARC Free Trade Agreement (SAFTA) in 2007 brought moderate tariff rates but rigorous tariff barriers that raised trade costs and hindered true trade potential between the countries. The authors assessed three FTAs i.e. the South Asian Free Trade Area (SAFTA), the India–Sri Lanka Free Trade Agreement (ISFTA), and the Pakistan–Sri Lanka Free Trade Agreement (PSFTA) assessed by applying gravity trade model estimation and revealed that the trade creation effects were identified in the ISFTA. The reason behind the predominant positive effects of ISFTA on Sri Lankan trade flows is its lowest preferential tariff rates [6]. Examine the free trade agreement (FTA) between Sri Lanka and China and its impact on partners including India by applying the GTAP. Its results revealed that it would be beneficial for Sri Lanka to substitute goods of Indian origin with goods of Chinese origin, thus Sri Lanka's trade with India would fall [7]. The role of trade in the economic growth of a nation has long been analyzed in various contexts and many academic literatures. Many authors have highlighted the role of the trade intensity index in measuring the intensity of trade between two countries. For providing a theoretical base for the trade intensity index, assumptions were drawn such as the structural similarity of the industry and trade of the two nations, their geographical closeness, historical relations, etc. This index evaluates whether the value of trade

between two countries is greater or smaller than expected based on their importance in world trade. On that pre-set ground, the degree of trade intensity is to be determined [8]. Trade intensity between Malaysia and Singapore for HS040630 (processed cheese, not grated or powdered) has been examined, and this trade intensity index is measured within the innovative idea of the GTISB diagram of a square box. Results indicate that Malaysia has had an intense trade relationship with Singapore throughout the years ranging from 2012 to 2017 [9]. Analyzed India's Trade Intensity with UAE for the period from 2006 to 2016 by using Trade Intensity Index (TII), results of the study show that India's trade with UAE is more intense and suggests measures to enhance trade intensity between these two nations [10]. Intra-BRICS and BRICS-EU trade flows have been examined and the findings of the trade intensity index (TII) reveal the existence of large bilateral trade flows among BRICS nations. Russia has emerged as the main trading partner with the EU in BRICS. The analysis revealed that India and China possessed comparative advantages in manufactured and processed products. The export similarity index highlighted the competition between India and China in the EU [11]. The bilateral trade relationship between India and the Republic of Korea (Korea) has been highlighted for the period 2001 to 2017 by using three indexes such as the trade intensity index, the intra-industry trade index, and the revealed comparative advantage index. This study revealed that India is dominating Korea in the primary sector and Korea has relatively more GDP in the industry and services sector than India. Thus, India and Korea can help each other by exchanging their ideas, experiences, and mutual development to improve competitiveness in these sectors [12]. Estimation of the trade intensity index and gravity model between Egypt and COMESA countries revealed that gross domestic product and the existence of sharing borders are the two important and effective variables that determine Egypt's trade with COMESA [13]. The Trade Intensity Index highlighted that Export and Import Intensities between India and Germany have declined over the period [14].

Research Gap

From a detailed review of the literature, it is found that studies are addressing India's bilateral trade relationship with the world including Sri Lanka. To the best of our knowledge comprehensive study addressing ISFTA with the application of trade intensity index (TII) is an untested phenomenon for the period 2002-2022. Thus, the uniqueness of this study is to examine India's trade intensity with Sri Lanka by applying the trade intensity index. This is a modest attempt to address a research gap in the existing literature.

Objectives of the Study

The present study aimed to explore the trade intensity and the potential of international trade relations between India and Sri Lanka post ISFTA. The following objectives are developed, to expedite identified aims:

- To analyze the trade statistics between India and Sri Lanka.
- To estimate the extent of trade intensity between India and Sri Lanka.

Research Methodology:

In this analysis, bilateral trade flows between India and Sri Lanka have been examined to know the trade potential and prospects of bilateral trade relations. This research is based on secondary data. For examining India's trade relations with Sri Lanka, data will be collected from an online database of IMF DOTS and reputed journals, etc. For the sake of analysis, sixteen years of data starting from 2002 to 2022 have been used. Besides, the Trade Intensity Index has been applied to identify trade potential markets for a country in terms of exports and imports.

Trade intensity index: The trade intensity index proposed by Kiyoshi Kojima [8] measures the intensity of bilateral trade between two countries and can identify the extent of their trade intensity with each other. The trade intensity index is classified into two forms; 'The Export Intensity Index' and the other one is 'Import Intensity Index'. The values of the Export Intensity Index or Import Intensity Index indicate that the country i's (India's) concentration of export or import to country j (Sri Lanka) is by country j's

(Sri Lanka's) relative import or export to world import or export. Export and Import intensities of India have been calculated to determine the India-Sri Lanka trade potential.

Range of values: The value of the index ranges from 0 to infinity. If the calculated value of Export Intensity Index or Import Intensity Index comes 0, it implies that there is no trade relationship between the partner countries. If the Export Intensity Index or Import Intensity Index is more (less) than 1 would indicate that the country i's (India's) concentration of export or import to country j (Sri Lanka) is greater (smaller) than the country j's (Sri Lanka's) relative import or export to world import or export. The higher is the index (i.e. more than 1), the better will be the country's exports or import possibility. Thus, this will help an exporter or importer in choosing the potential market.

Formulas: the trade intensity is calculated in forms such as Export Intensity Index and Import Intensity Index and this can be explained in the following manner:

(i). Export Intensity Index

$$XII_{ijt} = [X_{ij} / X_{iw}] / [M_{jw} / (M_w - M_{iw})] \quad (Eq. (1))$$

This formula represents exports intensity index of India to Sri Lanka. The symbols represents as follow;

XII_{ijt} = Export Intensity Index of India's Trade with Sri Lanka;

X_{ij} = Exports of India to Sri Lanka;

X_{iw} = Total Exports of India from the world;

M_{jw} = Total Imports of Sri Lanka from the world;

M_w = Total World Imports;

M_{iw} = Total Imports of India from the world;

t = 2002 to 2022.

(ii). Import Intensity Index of India's Trade with Sri Lanka:

$$MII_{ijt} = [M_{ij} / M_{iw}] / [X_{jw} / (X_w - X_{iw})] \quad (Eq. (2))$$

MII_{ijt} represents Import Intensity Index of India's Trade with Sri Lanka;

M_{ij} = Imports of India from Sri Lanka;

M_{iw} = Total Imports of India from the world;

X_{jw} = Total Exports of Sri Lanka to the world;

X_w = Total World Exports;

X_{iw} = Total Exports of India to the world;

t = 2002-2022.

An analysis of bilateral trade between India and Sri Lanka:

There has been extensive bilateral trade and economic cooperation between India and Sri Lanka. Agriculture, textiles, gems and jewelry, manufacturing, chemicals, information technology, and services are just a few of the many industries that are involved in the two nations' trading links.

Table 1: India-Sri Lanka Trade Statistics (in USD millions)

Year	India's Export to Sri Lanka	India's Import from Sri Lanka	India's trade volume with Sri Lanka	India's BOT with Sri Lanka	Export Growth	Import Growth	Trade Growth
2002	848.46	84.96	933.42	763.50	-	-	-
2003	1,219.64	168.76	1,388.40	1,050.88	43.75%	98.63%	48.74%
2004	1,345.11	321.88	1,666.99	1,023.24	10.29%	90.73%	20.07%
2005	1,871.80	527.87	2,399.67	1,343.92	39.16%	64.00%	43.95%
2006	2,197.85	497.39	2,695.25	1,700.46	17.42%	-5.77%	12.32%

Year	India's Export to Sri Lanka	India's Import from Sri Lanka	India's trade volume with Sri Lanka	India's BOT with Sri Lanka	Export Growth	Import Growth	Trade Growth
2007	2,682.76	590.99	3,273.76	2,091.77	22.06%	18.82%	21.46%
2008	2,880.51	431.25	3,311.76	2,449.26	7.37%	-27.03%	1.16%
2009	1,732.87	327.98	2,060.85	1,404.89	-39.84%	-23.95%	-37.77%
2010	3,313.93	519.67	3,833.60	2,794.25	91.24%	58.45%	86.02%
2011	4,806.93	718.99	5,525.92	4,087.93	45.05%	38.35%	44.14%
2012	4,193.79	638.93	4,832.72	3,554.86	-12.76%	-11.14%	-12.54%
2013	4,227.28	672.84	4,900.13	3,554.44	0.80%	5.31%	1.39%
2014	6,433.18	591.69	7,024.87	5,841.49	52.18%	-12.06%	43.36%
2015	5,526.18	853.89	6,380.07	4,672.29	-14.10%	44.31%	-9.18%
2016	3,910.61	631.95	4,542.56	3,278.66	-29.23%	-25.99%	-28.80%
2017	4,424.27	609.66	5,033.93	3,814.61	13.14%	-3.53%	10.82%
2018	4,662.49	1,318.91	5,981.40	3,343.58	5.38%	116.34%	18.82%
2019	4,227.53	993.47	5,221.00	3,234.06	-9.33%	-24.67%	-12.71%
2020	3,225.10	689.20	3,914.30	2,535.90	-23.71%	-30.63%	-25.03%
2021	4,793.63	978.50	5,772.13	3,815.13	48.64%	41.98%	47.46%
2022	6,180.51	1,043.71	7,224.22	5,136.80	28.93%	6.66%	25.16%

Source: Author's calculation based on data extracted from the International Monetary Fund, Direction of Trade Statistics (IMF DOTS) database

Table 1 provides data on India's exports to Sri Lanka, India's imports from Sri Lanka, India's trade volume with Sri Lanka, India's balance of trade (BOT), export growth, import growth, and trade growth with Sri Lanka. There is a gradual increase in India's exports to Sri Lanka from USD 848.46 million in 2002 to USD 6,180.51 million in 2022. With exports of USD 1,732.87 million in 2009, a year marked a slant because of the global financial crisis. Despite this, grew considerably in subsequent years, reaching a high of USD 6,433.18 million in 2014. Again, the pattern is changing, and exports to Sri Lanka declined

from 2015 to 2020. This might be due to the Sri Lanka-China Free Trade Agreement, which was inked in 2014 and allows Sri Lanka to import raw materials from China at cheaper rates. The decline in exports and total trade with Sri Lanka is mostly due to a global slowdown, which has been exacerbated by the COVID-19 pandemic.

India's import from Sri Lanka shows a gradual increase from USD 84.96 million in 2002 to USD 1,043.71 million in 2022. Data reveals that India imports an incredibly tiny bit from Sri Lanka; it proves a growth pattern. Such

relatively low quantities imply that the government should make decisions, like infrastructure development, and provide other incentives to improve this scenario. The trade volume demonstrates an increase from USD 933.42 million in 2002 to USD 7,224.22 million in 2022. The trade growth rate fluctuates year by year, with a peak of 86.02% in 2010 and a decline of -37.77% in 2009. India's balance of trade (BOT) with Sri Lanka shows a surplus (positive value) throughout the period of study, ranging from USD 763.50 million in 2002 to USD 5,136.80 million in 2022.

Overall, the trend analysis in figures and percentages highlights a gradual increase in export, import, and trade volume between India and Sri Lanka from 2002 to 2022. The growth rates fluctuate year by year, with some years experiencing significant growth and others witnessing declines. India's balance of trade (BOT) with Sri Lanka shows a surplus during the period of study.

Table 2 summarizes the India - Sri Lanka Bilateral Trade Intensity.

Table 2: India-Sri Lanka Bilateral Trade Intensity

Year	India's EII with Sri Lanka	India's III with Sri Lanka	Year	India's EII with Sri Lanka	India's III with Sri Lanka
2002	18.58	4.26	2013	10.18	1.98
2003	20.92	5.06	2014	12.04	2.31
2004	22.98	6.58	2015	17.24	2.73
2005	22.92	6.96	2016	12.00	2.40
2006	21.86	5.09	2017	12.66	2.40
2007	26.11	3.68	2018	11.20	2.48
2008	19.90	2.34	2019	11.24	2.49
2009	15.89	1.95	2020	12.04	2.84
2010	16.44	2.13	2021	11.88	2.54
2011	14.77	1.82	2022	12.11	2.29
2012	13.52	2.09			

(Source: Author's calculation based on data extracted from International Monetary Fund, Direction of Trade Statistics (IMF DOTS) database and Index is calculated by researcher)

It's worth noting that India's export and import intensities with Sri Lanka have been more than one in the past twenty-two years. Both nations have a significant trading relationship. As per the high export intensity index, India's export magnitude to Sri Lanka is larger than the latter's comparative demand from the world. Also, according to the higher import intensity index, India's import levels within Sri Lanka are slightly larger than the latter's relative supply to the world. It can be concluded that India has relatively higher export and import intensity than Sri Lanka.

The Indo-Sri Lanka Free Trade Agreement (ISFTA), signed on December 28, 1998, and fully implemented by March 2003, has shaped the bilateral trade dynamics between India and Sri Lanka. The ISFTA introduced duty-free concessions across numerous product lines, aiming to

enhance economic cooperation and support the trade of over 4,000 items from Sri Lanka to India on a duty-free basis. The agreement's full tariff liberalization was completed in 2008, marking a significant milestone in the trade relationship between the two countries.

A detailed analysis of India-Sri Lanka bilateral trade intensity from 2002 to 2022 reveals the evolving influence of the ISFTA on trade intensity levels. As indicated in Table 2, both India's Import Intensity Index (III) and Export Intensity Index (EII) with Sri Lanka exhibit notable fluctuations, reflecting the broader impact of the FTA, sector-specific trade variations, and economic events.

Impact of ISFTA on Trade Intensity

Early Phase (2002–2008):

Initially, from 2002, the EII stood at 18.58, indicating a solid start to trade intensity after the Indo-Sri Lanka Free Trade Agreement (ISFTA) came into effect in 2000. The III was 4.26, reflecting initial efforts by both countries to establish a bilateral trade relationship under the FTA. There was a noticeable rise in both indices as the III increased to 5.06, and the EII reached 20.92 in 2003. This growth highlighted the benefits of the FTA, likely spurred by Sri Lanka's early access to duty-free entry into India's extensive market. In 2004, Trade continued to grow as the III climbed to 6.58, and the EII rose to 22.98, indicating that the FTA significantly expanded bilateral trade, with increased demand for Sri Lankan exports in India. [15] By 2005, discussions surrounding the Comprehensive Economic Partnership Agreement (CEPA) began, further cementing the intent to broaden trade cooperation through investments, services, and additional trade liberalizations [16]. With import and export intensity indices showing upward trends, Sri Lanka's product lines like rubber, spices, and select agricultural goods benefitted substantially from this duty-free access. 2005 was the peak year for III, which reached 6.96, while the EII stayed relatively high at 22.92. This period saw the highest import intensity, reflecting increased Indian imports of Sri Lankan products, including apparel, rubber products, and electronics. The III saw a slight decline to 5.09 in 2006, but the EII remained high at 21.86. This steady export intensity demonstrates the continued impact of the ISFTA in facilitating trade. The EII peaked at 26.11, while the III decreased slightly to 3.68 in 2007, marking the highest export intensity achieved within the period, showcasing the ISFTA's success in enhancing Sri Lankan exports to India, and indicating expanded market access enabled by the ISFTA. This phase saw rapid growth in the export intensity of India's goods to Sri Lanka, showcasing the agreement's initial positive effects. However, in 2008, political concerns from Sri Lankan industries led to a standstill in CEPA negotiations despite the economic synergy achieved thus far. During this year, both indices saw declines, with the III dropping to 2.34 and the EII to 19.9. The global economic downturn likely

contributed to these reductions, though trade relations remained strong.

Middle Phase (2009–2015):

In 2009, the III and EII continued to decrease, reaching 1.95 and 15.89, respectively, reflecting the economic slowdown and the subsequent adjustment in bilateral trade activities. Despite the drop, ISFTA's duty-free concessions helped cushion the effect of the downturn. A mild recovery was seen with III rising to 2.13 and EII to 16.44, as both countries adapted to post-recession challenges in 2010. Growth in exports of products like cloves, pepper, natural rubber, copper wires, animal feed, refined copper, new pneumatic tyres, etc. helped sustain trade. The indices rose slightly in 2011, with III at 1.82 and EII at 14.77, indicating gradual stabilization as trade increased, particularly in high-demand items like insulated wiring sets and cables, bottle coolers, petroleum products, cocoa products, technically specified natural rubber, marble, furniture, MDF boards, apparel & clothing accessories, glass products, rubber gloves, nutmeg, mace, etc. The Department of Commerce has issued 4,371 Certificates of Origin under the ISFTA from January to May 2011 when compared to 4,112 Certificates of Origin under the ISFTA issued during the same period in 2010 [17].

A marginal increase brought the III to 2.09, while the EII declined slightly to 13.52, reflecting steady, though moderated, bilateral trade activity as both economies adjusted to changing market conditions in 2012. In 2013, III was at 1.98 and EII dropped further to 10.18, highlighting a period of moderation where both countries experienced slowing trade momentum. In 2014, the III increased to 2.31, and the EII to 12.04, marking a slight shift as both countries focused on regaining trade momentum in light of regional competition. Despite these fluctuations, the FTA facilitated a rebound by 2015, trade intensity rebounded with the III jumping to 2.73 and EII rising to 17.24, as both countries leveraged the FTA to boost trade following economic adjustments.

Recent Phase (2016–2022):

Trade indexes steadied after dips in 2017 with III at 2.40 and EII at 12.66, maintaining stability as trade continued under consistent ISFTA guidelines. In 2019, the III rose to

2.49, while the EII fell to 11.24, suggesting increased Indian demand for specific Sri Lankan imports. During the pandemic of 2020, the III held relatively steady at 2.84, while the EII was 12.04. The ISFTA helped sustain trade flows despite global disruptions. Trade indices slightly declined in the year 2021, with the III at 2.54 and EII at 11.88, by 2022 with III at 2.29 and EII at 12.11, pointing to a new standard for routine commercial transactions under the ISFTA.

From 2016 onwards, the trade intensity stabilized but at relatively lower levels compared to earlier years. The lower values suggest a plateau in trade growth, despite the foundational support provided by ISFTA. Market diversification challenges, such as dependency on the US and EU markets and Sri Lanka's limited supply capacity, have constrained the full exploitation of India's market. Additionally, factors like Sri Lanka's limited domestic supplies of certain export goods have contributed to the reduced intensity [15].

The ISFTA has certainly catalyzed Sri Lanka's trade with India, enabling significant growth in sectors where Sri Lanka holds a comparative advantage. However, the missed opportunity to expand into the CEPA framework has meant that some non-tariff barriers (NTBs) and limitations remain unaddressed. For example, while the ISFTA allowed for preferential access, unresolved issues related to regulatory alignment and NTBs have constrained further integration and expansion. This limited framework has affected Sri Lanka's ability to diversify within India's vast consumer market.

The data also indicate that trade intensity fluctuates with external economic pressures and domestic supply limitations, underscoring the importance of broader economic cooperation for sustainable trade growth. Sri Lanka's export resilience under ISFTA reflects strategic benefits, yet the potential for enhanced engagement remains unfulfilled without the CEPA's comprehensive structure. This analysis highlights the ISFTA's effectiveness in providing initial market access while pointing to a need for future policy frameworks, such as CEPA, to enhance and sustain bilateral trade intensity.

Conclusion:

India-Sri Lanka has a thriving and expanding trade and business relationship that has grown significantly over the years and with the India-Sri Lanka free trade agreement (ISFTA), both countries have widened their economic space. Hence, this study aims to examine bilateral trade flows between India and Sri Lanka by applying the Trade Intensity Index to know the trade potential and prospects of bilateral trade relations. All Export and Import related data collected starting from 2002 to 2022 from IMF DOTs database.

It may be inferred that India has invariably had a Trade Intensity Index larger than one Sri Lanka, indicating that trade is surging. Higher export and import magnitudes from 2002 to 2022 indicate remarkable trade links between the two nations. So, it may be argued that India has a stronger export and import intensity with Sri Lanka. However, the tendency for export and import intensity fluctuates over time due to a variety of factors such as the global financial crisis in 2008 and the ratification of the Sri Lanka-China Free Trade Agreement in 2014, the global slowdown and the COVID pandemic. Thus, India must try to find the ways to regain the same trade intensity levels that were not affected by any surrounding challenges. Since both nations possess significant bilateral trade relationships, India must strive to regain previously attained trade flows as well as broaden the trade spectrum between the countries. Hence, more bilateral trade growth is possible suggesting that there is a lot of scope for trading between the two countries.

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