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EU Green Deal and Implications for Sri Lanka's Exports

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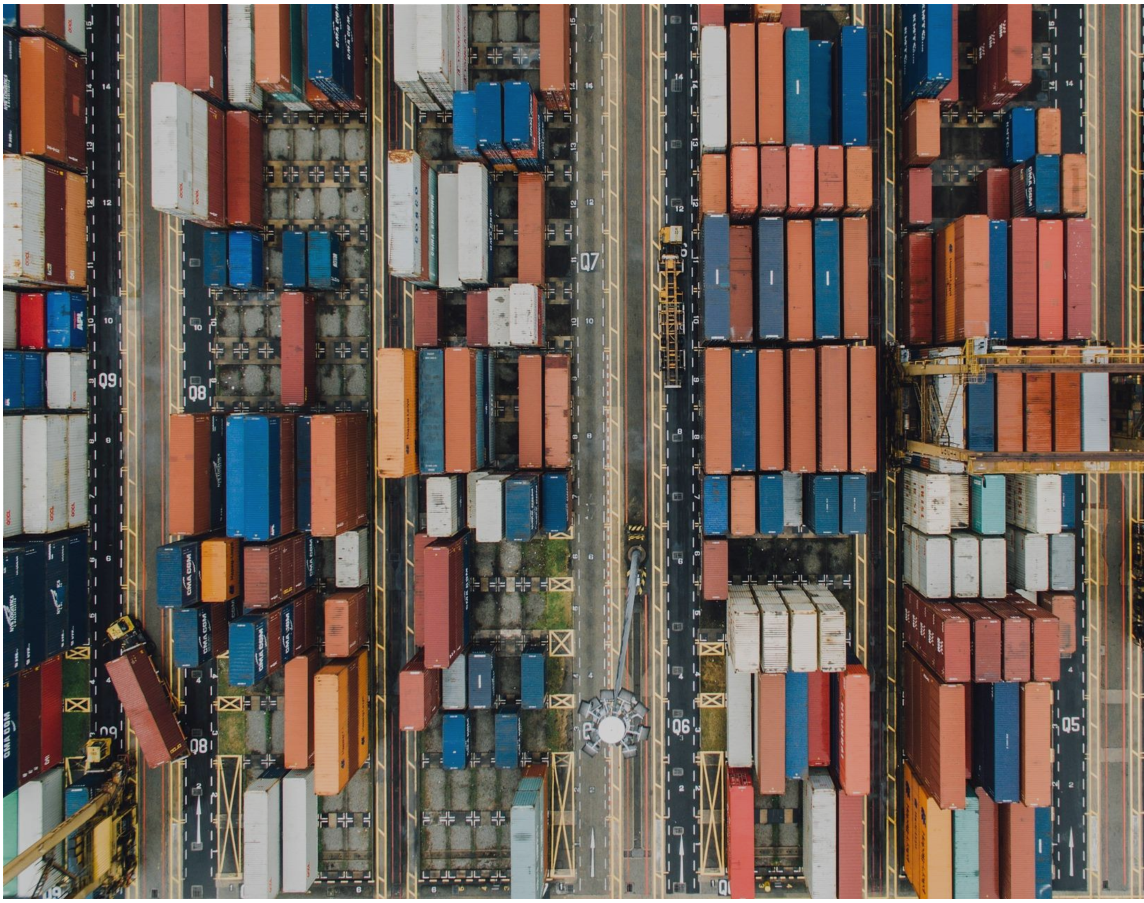

KEY TAKEAWAYS

- The EU is a prominent export market for Sri Lanka. **Recognizing the shifts being brought on by the European Green Deal**-EU's most ambitious and comprehensive set of environmental laws and regulations ever passed-is vital.
- This Policy Brief finds that while some aspects of the EGD will have immediate implications, others are unlikely to affect Sri Lanka in the near-term.
- It also observes that **Sri Lanka is notably absent from global, strategic trade policy discussions on the EGD**, whereas peer countries are active on this front.
- It recommends that industry and government stakeholders collaborate to offer more support to SME exporters to better navigate the changes, enhance their readiness to meet market requirements, and ensure they remain competitive in the European market.
- We flag four areas for action **- Government support, Public-private partnerships, International cooperation and bilateral engagement, and Industry support to SMEs.**

The European Green Deal is arguably one of the most far reaching pieces of trade and industrial policy seen in the current era of international trade. It is a multi-faceted plan passed by European lawmakers to make Europe climate-neutral by 2050 but has implications for global trade far beyond the borders of the European Union (EU). This policy brief explores what the channels of impact there are for Sri Lanka's export sector, especially for small and medium enterprises (SMEs), and argues that - given the materiality of EU as an export market for the country - policymakers, industry groups, and international organizations must take urgent steps to help firms step up their readiness and compliance.

It is well known that the EU is a major trading partner for Sri Lanka. With a share of 15.1% of Sri Lanka's overall trade in 2022, the European Union (EU) is the country's most important trading partner and the second most important export destination (after the US)[1]. Historically, apparel, rubber, and coffee, tea, mate, and spices have been Sri Lanka's top exports to the EU, amounting to US$1.61 billion, US$419.78 million, and US$162.11 million respectively[2]. As such, changes to EU policy that impinge on trade - like parts of the European Green Deal (EGD) - will necessarily have an impact on Sri Lanka. It comes at a time when Sri Lanka is navigating the challenges of compliance with (and continuity of) the GSP Plus scheme of unilateral tariff preferences, higher domestic production costs on account of high price levels and higher utility costs, a stronger currency, and weaker balance sheets of companies due to successive macroeconomic shocks since 2009.

Snapshot of the EGD

Proposed in December 2019 by the European Commission, in collaboration with the European Council, the EGD is the EU's largest and most ambitious integrated programme of reform, investment, and research centered around climate change[3]. It was adopted by the European Parliament in January 2020, and each component of it comes into force at different times[4].

According to the European Commission, the EGD is a "comprehensive package of policy initiatives aiming to transform Europe's economy into a modern, resource-efficient5, and competitive one".

The goal of the EGD is to ostensibly make Europe the world's first climate-neutral continent by 2050, achieving net-zero greenhouse gas emissions[6]. Through it, the EU expects to drive new consciousness around climate and environmental issues across the EU's trade relationships globally. Listed below are some of the key components of the EGD that were adopted and are now in different stages of implementation and adopted.

Policy Initiative	Year Proposed (by the European Commission)	Year Adopted (by the European Parliament)	Implementation Status
Carbon Border Adjustment Mechanism	2019	2023	Currently in the transitional phase
Critical Raw Materials Act	2023	2024	Fully implemented
Corporate Sustainability Due Diligence Directive	2022	2024	Currently in the transitional phase
European Hydrogen Strategy	2020	2020	Fully implemented
European Methane Regulation	2020	2024	Fully implemented
Offshore Renewable Energy Strategy	2020	2023	Fully implemented
European Union Deforestation Regulation	2019	2023	Currently in the transitional phase

This policy brief selects three of the above - the Carbon Border Adjustment Mechanism, the Corporate Sustainability Due Diligence Directive, and the European Union Deforestation Regulation — to assess their possible direct and/or indirect trade implications for Sri Lanka.

Carbon Border Adjustment Mechanism

In October 2023, the EU introduced the Carbon Border Adjustment Mechanism (CBAM) — the world's first carbon border tax, as measure to prevent goods imported from outside the EU from gaining a competitive advantage because their countries of origin do not account for carbon costs[7].

According to the European Commission, the CBAM currently applies only a selected number of goods at high risk of carbon leakage: aluminum, cement, electricity, hydrogen, iron and steel products, and mineral and chemical fertilizers[8]. To understand how the CBAM works, consider the following scenario: suppose you are an EU importer of a CBAM-subjected product from Sri Lanka. Under CBAM, you must report the carbon emissions associated with the production of the product, and these emissions are then compared to the EU's benchmark for that product. If it exceeds the benchmark, the EU importer will be liable to pay a CBAM charge.

This charge is calculated based on traded tonnage, emissions factors, and the EU Emissions Trading Scheme (ETS) market price[9]. To settle this charge, the EU importer must purchase CBAM certificates corresponding to the calculated amount. However, if the Sri Lankan exporter has already paid a carbon price and can provide proof of this payment, it can be deducted from the CBAM charge[10].

It is important to note that the onus of responsibility is on the EU importer to report the emissions and settle the charge to clear their shipment.

But effectively, this burden is passed upstream in the supply chain. The burden of proving the carbon price of the product and whether it has been paid or not will cascade down the supply chain to the exporter, who will need to provide the necessary documentation and proof.

Implications for Sri Lankan exports

According to research by the Asian Development Bank (ADB), cement is Sri Lanka's most exposed CBAM product, followed by iron and steel[11]. But given the very low export volumes, Sri Lanka's impacts from CBAM is likely to be negligible. In 2022, Sri Lanka exported $137,000 worth of cement globally[12] with $14,304 sold to the EU[13], accounting for 10.44% of the country's total cement exports.

Sri Lanka exported $81.8 million worth of iron and steel globally[14], with $2.43 million sold to the EU[15], accounting for 2.97% of its global iron and steel exports. Apart from the fact that only 2.97% of iron and steel (Sri Lanka's 24th most exported product[16]) is exported to the EU, it is interesting to note that Sri Lanka records a negative CBAM score for iron and steel[17]. This indicates that the carbon emissions of Sri Lankan-produced iron and steel are lower than the EU benchmark, potentially making them preferable to EU importers[18].

It is important to note that CBAM does not apply to Sri Lanka's top export categories of apparel, tea, coffee, spices, and rubber[19]. So, the US$ 2.1 billion of export earnings from the EU in these categories are not at risk.

Potentially due to its limited immediate impact, Sri Lanka seems to not have taken a policy stance [on CBAM] with the EU, or done any domestic preparatory work. Yet, Sri Lanka's geopolitical neighbours have.

Both China and India, argue that the CBAM is a punitive measure disguised as an environmental initiative[20]. New Delhi is even considering challenging the CBAM at the World Trade Organization (WTO)[21], claiming it constitutes an unfair trade barrier poised to cripple India's exports of energy-intensive items, which make up 26.6% of the country's exports to the EU[22].

New Delhi contends that because of the CBAM, the Indian export market is likely to encounter a drop in demand and increased competition for their products within the European economy[23]. India and the EU are currently in discussions on these contentions[24].

A key point to remember is that even though the CBAM has a limited effect on Sri Lanka in the immediate future, by 2030 the scope of CBAM-applicable products is expected to extend to all product groups covered by the EU ETS. Crucially, this includes rubber[25] — one of Sri Lanka's major exports. Therefore, it is advisable that Sri Lankan policy and industry stakeholders begin looking at the details of CBAM applicability on exports like rubber, decide the policy stance on it and engage with the EU as well as take required domestic preparatory measures.

Corporate Sustainability Due Diligence Directive

Introduced in May 2024, the Corporate Sustainability Due Diligence Directive (CSDDD) requires companies to establish due diligence procedures to address the adverse consequences of their actions on human rights and the environment, to ensure responsible and sustainable corporate behavior across global value chains[26]. According to the European Commission, the CSDDD applies to EU companies with over 1000 employees and an annual turnover exceeding €450 million, as well as large non-EU companies generating the same turnover within the EU[27]. In turn, this will have implications up the supply chain.

To understand how the CSDDD works, consider the following scenario. Suppose you are an EU fashion retailer, and you source your materials from suppliers in India and China. Next, your materials are sent to a factory in Sri Lanka where the garments are made by an medium-sized manufacturer. Once completed, the finished garments are shipped to your distribution center in Italy, and from there they are distributed to customers across the EU. Under the CSDDD, you are required to ensure that at each step of this process, you and your upstream and downstream partners uphold the human rights of all individuals involved throughout the supply chain and adhere to environmental protection standards. Failure to comply with these obligations will result in penalties[28]. The EU has identified the apparel sector as having a high risk of human rights and environmental violations[29]. Consequently, the EU fashion retailer will scrutinize the Sri Lankan firm's compliance more rigorously. Given that apparel is the top export from Sri Lanka to Europe, with a value of $1.5 billion in 2022[30], ensuring adherence to the CSDDD is crucial for maintaining access to the European market.

This might not be too much of a competitive challenge for Sri Lankan suppliers, considering that the ethical manufacturing standards are often seen as higher than competitors like Bangladesh and Vietnam, and environmental standards of factories are improving.

The focus will need to be on the SME manufacturers which may not have advanced in these areas as much as the top tier exporters have - because if not, they could soon loose market share.

Learning from Germany's GSCDDA

Currently, the CSDDD is in its transition phase, meaning that EU member states are in the process of transposing the CSDDD rules into their own national corporate due diligence acts. They will have two years (to 2026) to complete this process[31]. At present, there is little information on how companies and their upstream and downstream partners can prove compliance with CSDDD in each of the different EU countries. Yet, Germany's early adoption of similar rules provides some indications. In early 2023, Germany introduced its German Supply Chain Due Diligence Act (GSCDDA), and as of January 2024 it is fully implemented and applies to all German companies with a minimum of 1000 employees and foreign companies with branches in Germany of the same size[32]. The GSCDDA mandates companies to implement a risk management system that covers its entire supply chain33. The risk management system helps companies assess, mitigate, and monitor human rights and environmental risks in the company's supply chain34.

Germany is Sri Lanka's fourth-largest export destination[35]. Since the implementation of the GSCDDA, all Sri Lankan exporters have been instructed to ensure supply chain diligence by implementing robust traceability solutions, conducting regular site-level audits, establishing comprehensive reporting mechanisms, and obtaining sustainability-related certificates[36]. If Sri Lankan exporters fail to comply with their due diligence obligations, it could result in penalties, a temporary suspension of business relations, or the exporter company being temporarily removed from the list of companies that the German importer can consider for contracts[37].

So far, larger Sri Lankan manufacturing exporters have been able to comply with the GSCDDA[38], however, small and medium-sized enterprises (SMEs) in apparel and textile, food and agriculture, and rubber sectors have been finding it difficult to prove their compliance[39]. To assist them, the German Delegation of Industry and Commerce in Sri Lanka (AHK), in partnership with the Friedrich Naumann

Foundation for Freedom in Sri Lanka, and Löning Human Rights & Responsible Business, conducted a series of workshops[40]. These workshops guided over 60 SMEs on the technical aspects of the GSCDDA, and how to map their own business due diligence processes to comply with international sustainable supply chain requirements[41].

Within the next one and a half years, all EU member states, who are modeling the GSCDDA because it shares foundational similarities with the CSSDA, will implement their own CSDDDs. Given the importance of the European market, Sri Lankan exporters need to step up compliance readiness with CSDDD regulations in order to maintain their access to the European market. Partnerships between the government, industry associations, and EU agencies are needed to help SMEs in particular navigate these rules, obtain required certifications, and prepare expeditiously.

European Union Deforestation Regulation

In June 2023, the EU introduced the European Union Deforestation Regulation (EUDR) to limit the EU's impact on global deforestation, forest degradation, and biodiversity loss by promoting deforestation-free supply chains, ultimately reducing the EU's contribution to greenhouse gas emissions[42].

The EUDR is currently in its transitional phase and is expected to be fully implemented by the end of 2024[43]. Upon full implementation, the regulation will require companies trading in seven key commodities — soy, cattle, oil palm, wood, cocoa, coffee, and natural rubber — as well as their derived products, to provide proof that their supply chains do not include products originating from recently deforested land or that have contributed to forest degradation[44].

To understand exactly how the EUDR works, consider the following scenario. Suppose you are a Sri Lankan exporter that sells rubber-based products to the EU. Under the EUDR, you are mandated to gather detailed information about the production of your rubber products, including geographic coordinates of the land plots where you harvest rubber and produce your products, information on the quantity produced, and evidence of legal harvesting[45]. You must then compile all this information into a due diligence statement, which must be submitted through the information system maintained by the European Commission for a review and verification process[46]. Once submitted, you will be notified of the outcome of the process[47]. If you are unable to comply with the due diligence obligations, you may be subjected to a penalty from the EU importers[48] or a suspension of your business in the European market[49].

As a Sri Lankan rubber products exporter, access to the European market is important. In 2022, nearly half of Sri Lanka's US$ 1 billion rubber and rubber products exports[50] was sold to EU buyers[51]. It is clear, therefore, that Sri Lankan government and industry stakeholders need to focus on the heightened compliance requirements stemming from the EUDR, to preserve and grow market access.

Responses to the EUDR

Sri Lanka seems to have begun initial discussions about the EUDR and its implementation[52]. In March 2024, the Sri Lankan Foreign Ministry, in collaboration with the EU Ambassador to Sri Lanka, and the Directorate-General for Environment of the European Commission in Brussels, hosted a hybrid information session for exporters[53]. The session provided industry and government officials with a comprehensive overview of the EUDR and guidance on how Sri Lankan exporters can seek technical assistance from the EU to comply with the new procedures[54]. It is unclear at this point what the status of Sri Lanka's preparedness for full EUDR compliance is, considering the looming timeline of end-2024.

Meanwhile, Sri Lanka could look at other countries' response on EUDR for an understanding of options it can pursue in its advocacy.

In June 2024, representatives from 17 countries[55] signed an open letter addressed to the EU Commission and Parliament, expressing several concerns on the EUDR[56].

Brazil raised issues with the EUDR country benchmarking system that classifies countries as low, standard, or high risk for deforestation or forest degradation[57]. Products from high-risk countries (or parts thereof) will be subjected to more scrutiny and import requirements[58], while the due diligence process will be simplified for low-risk countries[59]. Although the finalized list of classified countries and parts thereof is yet to be published[60], Brazil argues that this system imposes unfair, differentiated conditions for access to the European market[61]. Similarly, Indonesia, a major supplier of the applicable commodities, contends that the country benchmarking system disregards these countries' efforts to balance nature conservation with people's livelihoods[62]. Paraguay, one of the world's largest exporters of corn and soybeans, has labeled the EUDR a 'protectionist measure disguised as an environmental policy', asserting that it will significantly impact production costs, increase food prices, and distort global food trade[63]. These countries have called for delays in the implementation of the regulation, advocating for a period of 'open dialogue' during which revisions can be made[64]. Similar requests for an extension have been made by cocoa farmers, with notable appeals coming from the African continent. In July 2024, the Cocoa Farmers Association of Nigeria (CFAN) wrote an open letter to the EU Commission requesting an extension of the EUDR implementation to the end of 2025[65]. The association expressed concerns that failure to extend the deadline could severely impact the livelihoods of cocoa farmers. They emphasized that smallholder cocoa farmers[66], who have been hindered by insufficient information about the EUDR at the farm level, require additional time to adequately prepare for compliance with the new regulations[67].

However, the EU Commission has confirmed its commitment to the implementation timeline, which is set for the end of 202468.

Summary View of Implications for Sri Lanka

Sri Lanka's reliance on the EU as an export market means that EU legislation and regulation necessarily has implications on our exporters. The EGD - the most comprehensive set of rules and regulations by the EU so far, should be a key focus for Sri Lankan policymakers, industry associations, and government agencies working on trade. Some parts of the framework have little immediate implications for Sri Lanka (like the CBAM), whereas others do (like the CSDDD and EUDR).

This policy brief has not attempted to measure the impacts empirically, but rather aims to put forward a first look at the implications, to draw attention of international trade stakeholders.

In summary, the immediate impact of CBAM on Sri Lanka is limited, as it primarily affects sectors like cement, iron, and steel, which constitute a small fraction of the country's exports. However, as the scope of CBAM expands, future implications for major exports such as rubber, could become more pronounced. The EUDR's forthcoming full implementation presents a challenge for some Sri Lankan export sectors, notably rubber. Industry would necessarily need to collaborate with government on the EUDR compliance, given the emphasis on land use, traceability, and forest management. The CSDDD, while still in transition, poses significant compliance burdens on Sri Lankan exporters, particularly SMEs. Violations of CSDDD obligations can result in penalties, including fines of at least 5% of a company's total net worldwide revenue, civil liabilities, and reputational risks for companies within the scope of the CSDDD. Consequently, these European and foreign companies importing from Sri Lanka will be meticulous in ensuring their suppliers hold internationally-recognized certifications, robust risk management systems, comprehensive reporting mechanisms, and the ability to address any human rights or environmental violations promptly.

Typically, larger companies have the financial, managerial, and technical capacity to meet these stringent requirements. SMEs, however, may face considerable challenges due to limited access to finance, technical assistance, and human resources.

Risks and Opportunities for SME Exporters

We assert that SME exporters are likely to be disproportionately affected by the implementation of the CSDDD, but also SME exporters that have inclusive and regenerative practices at the core of their business models will stand a better chance of increasing their business with EU buyers.

As the EU Green Deal clearly indicates, the European consumer is going to be much more attuned to the environment and climate credentials of products in their market. This is expected to create a growing demand for products that are more nature-based and climate-friendly. Sri Lankan SMEs can capitalize on this demand. Moreover, Sri Lanka's unique biodiversity and nature-based agro products can be well-positioned for niche segments in the EU. As EU companies increasingly prioritize sustainable supply chains, Sri Lankan SMEs that can demonstrate sustainable practices will be more attractive to European buyers. We call on industry and government stakeholders to collaborate to offer more support to SME exporters (including for obtaining expensive standards and certifications) to better navigate these changes, enhance their readiness to meet market requirements, and ensure they remain competitive in the European market.

Implications for Policy and Industry Advocacy

In our research on other developing countries' approaches to comply with these new regulations, we find that many of them have been a) active in advocating for their countries' and their exporters, in various EU and multilateral fora; b) they have joined up with peer countries to put forward common positions; c) they have taken strong bilateral diplomatic stances, both with their EU delegations in the home country, as well as through their Ambassadors/High Commissions in Brussels; and d) conduct domestic gap analysis and commence programmes to help prepare domestic exporters (especially SMEs), often supported by European donors. Our research found little evidence of most of these areas for Sri Lanka (apart from a handful of information sessions being held), and this was confirmed by expert interviews with industry players.

Given the materiality of the EU market for Sri Lankan exports, this is both surprising and troubling.

The compliance regimes in international trade are only expected to heighten, not reduce, and so both policy and industry stakeholders need to take collaborative action.

The implications of these, and other EU Green Deal components can evolve as these regulations are fully implemented. Therefore, Sri Lanka must diligently monitor the developments, critically evaluate their impact, and respond accordingly, whether by accepting and adapting to these new regulations, or by taking policy stances on them in bilateral and multilateral fora.

Recommendations

We summarize four (4) areas for action:
1. Government Support: The government would need to provide support through direct and indirect (donor funding) sources to help exporters meet the new compliance requirements, and make the necessary investments in people, technology and processes. While fiscal incentives are unlikely given the ongoing IMF programme, other financial incentives can be explored - like carving out a funding window from recently launched SME loan schemes to pay for expensive certifications and standards improvements.

The government must also focus on reducing other trade facilitation barriers at the border which are entirely within its control, to reduce behind the border costs for exporters to the EU. At a diplomatic and trade policy level, Government officials should engage with EU bodies to advocate on behalf of export sectors impacted by the new rules.

2. Public-Private Partnerships: Collaborations between the government, private sector, and development partners are needed to facilitate knowledge transfer and technical assistance. This can help reveal the implementation gaps and resourcing needs, and work on reducing the time needed for firms to adapt and adopt internal changes to meet the new compliance requirements.

3. International Cooperation and Bilateral Engagement: Engaging with EU institutions and businesses can help Sri Lankan SMEs understand the evolving regulatory landscape and access new markets. Apart from government-/policy-level discussions, international cooperation at a business-to-business level can help improve understanding and readiness of Sri Lankan exporters. This cooperation can also focus on dialogue between importer groups in the EU that are relevant to Sri Lankan products, and Sri Lankan suppliers of those products.

4. Industry Support to SMEs: Business Member Organizations (BMOs) like chambers of commerce and trade associations need to orient their

services to help SMEs enhance their readiness. Programmes can prioritize improving SMEs' sustainable practices, investments in certifications, and building strong relationships with EU buyers. BMOs can forge partnerships with peer organizations in EU countries, to help improve their own understanding of evolving EU requirements.

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The urbanisation and cities theme at CSF is led by Colombo Urban Lab (CUL). CUL works towards equitable and sustainable cities in Sri Lanka by advocating for research driven policy making where the lived experiences of citizens form the basis of a city's development. It is a collaborative and interdisciplinary space, enabling connections between research, practice and public policy. Our research and advocacy themes include infrastructure, food environment, climate change, social security and public space.

A Publication under CSF's thematic pillar on: International Trade & Competitiveness

Research and policy engagement on key policy issues relating to trade, investment, and competitiveness, with pragmatic recommendations for action by private and public sectors. Ongoing work includes research on the nexus between environment and trade, advisory work on policy reforms in FDI, productivity, and SME development, and research for the Parliament's Sectoral Oversight Committee on International Relations

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