Introduction and summary

In October 2006 a European Union-Indian High Level Trade Group agreed the parameters for an ambitious Free Trade Agreement between the EU and India. It was part of the EU's Global Europe initiative which aimed at setting up agreements with large and rapidly growing markets around the world. On its part, India relished the prospect of preferential access to the major market of the EU, which already took more than a quarter of its exports. The mutual mercantile attractions of the two partners are not hard to see, but there is scope to worry about whether an FTA is the right approach, whether the FTA that actually emerges will be appropriate to the challenges and opportunities that exist and, most importantly for this publication, whether an FTA will harm the many countries which it excludes. This publication deals with the possible impacts of an EU–India Free Trade Agreement on the excluded countries.

Although they remain perfectly amicable, the talks between India and the EU have not made rapid progress since their inception, so we currently have little idea how an FTA will turn out. But excluded countries' policy interest in it is strong, not least because it may not yet be too late to influence the outcome of the negotiations. Thus, the Commonwealth Secretariat has sought information and that is what we, as economists, seek to provide. We proceed in two ways: in the discursive sections of this paper – mainly Part I on the background and Part III on the services sector – we discuss the possibilities about the final form of the agreement. We believe that there will be slight progress on deep integration (regulations etc.) but rather more on liberalising services trade between the EU and India. Services trade accounts for over a quarter of the parties' international trade and over half of their economic activity. We are not able to offer numerical estimates of the height of trade barriers in services, let alone the effects of removing them – partly because the data are so poor – but we are able to identify a number of important factors which excluded countries may wish to monitor and consider as the talks between the EU and India proceed. Of course, the discussion is all speculation, but not uninformed speculation, because most of the authors have written on the subject before (Gasiorek, 2007), spoken at length to policy makers on both sides of the table, and are informed about general policy stances in both partners.

In Part II, which provides a formal and quantitative analysis of the FTA's consequences for goods markets, we have to make some simple and concrete working assumptions in order to be able to explore the possible consequences of an FTA on excluded countries. These are:

- that current tariffs are fully enforced and collected;
- that all tariffs on mutual EU–India trade are reduced immediately to zero; and

- that the parties are not able to agree far-ranging deep integration in the goods market in the form of regulatory harmonisation, etc.

The assumption of immediate zeros on tariffs within the FTA allows us to avoid the danger of being thought to bias the results with our own estimates of the outcome and allows the clear understanding that our estimates are upper bounds of the effects that the FTA will actually have. We mainly analyse data from the period 2003–05 and so implicitly we are assessing the situation that would have arisen if the FTA had already been in existence by then. Given India's current rapid rate of economic growth, it is worth recalling that the relative importance and size of the Indian economy will be increasing through time, so that when an FTA actually comes into operation, its effects may be somewhat larger than we have indicated. Given all the other uncertainties, however, we make no attempt to factor such growth into our calculations.

One method often used to quantify the effects of prospective trade agreements is simulation modelling. This produces a highly consistent theoretical view of the trade agreement, but one which necessarily ignores many possible dimensions and lacks empirical detail in many dimensions. We do not adopt a simulation approach here, but rather focus on identifying a number of key indicators of the likely effects of the FTA and calculating them from recent historical data. The analysis is mainly conducted at a very high level of disaggregation – e.g. the 6-digit level of the Harmonised System (HS) of trade classification, which recognises over five thousand products, or disaggregations of it. Hence, while we are not able to offer the apparently precise predictions of welfare gains or losses to excluded countries that arise from simulation modelling, we are able to offer a good deal of qualitative and order-of-magnitude insight about the effects of the EU–India FTA based on extremely detailed international trade data which cannot be achieved using alternative methods such as CGE modelling.

This publication comes in four substantive parts. Part I presents a more detailed background to the discussion of the effects of an EU–India FTA on excluded countries. It starts by discussing the theoretical basis on which one should consider the welfare consequences of 'regional' trading arrangements on excluded parties. The usual approach is to consider only 'trade diversion' whereby, as a result of offering India preferential access to the EU market, the EU purchasers switch from importing from an efficient excluded country to importing from (a less efficient) India, and similarly for India's preferences to the EU. This diversion is attractive to private purchasers in the EU who are now able to buy from abroad without paying the import tax, but it is costly to the EU because, tax aside, it is paying more for its imports; the fact that EU purchasers preferred the excluded country source when it paid the same tax as India, strongly suggests that it is a more efficient source. Trade diversion is also held to be harmful to the excluded country because it involves its exports being lower than they would otherwise have been. We refine this analysis to note that a decline in exports is economically harmful in the long run only when the lost exports commanded prices in excess of the cost of their production and sale. This is certainly possible, but in competitive markets for simple goods is far from inevitable. We also argue that potentially as significant as a decline in exports is a decline in the prices that excluded countries can command for their exports – that is, that FTAs cause

deteriorations in excluded countries' terms of trade. We note that this latter effect usually makes FTAs harmful for excluded countries and we offer a few brief examples from other countries' experience.

Part I then goes on to discuss what an EU–India FTA might cover. We start with a brief sketch of the history of European preferential trading arrangements and show how the Global Europe initiative increased the EU's propensity to sign discriminatory agreements with larger developing countries. One feature of the Global Europe initiative is its emphasis on so-called 'deep integration' – the harmonisation of regulations, the reduction of other 'behind-the-border' barriers to trade and the liberalisation of trade in services. We discuss what this might entail and conclude that important though it undoubtedly is, the prospects for the EU and India agreeing to much deep integration are pretty slim.

Finally, we examine estimates of the effect of an EU–India FTA on the partners themselves. This is not our focus here, but we draw on a number of simple statistics and other studies to see what the partners might get from an agreement. This helps us to understand the incentives for the agreement to proceed and also to think about its effects at a sectoral level.

Part II of this book analyses the markets for goods explicitly from the point of view of excluded countries. It starts by asking whether they export similar sets of goods as the partners do to each other. If they do, the presumption is that they will be more vulnerable to their trade being diverted as the partners' mutual trade is increased by the preferences they offer each other. The answer is that most developing countries have only modest overlaps with India's exports to the EU and the EU's to India.

Next we ask to what extent the FTA will reduce tariffs on partner exports of goods that the excluded countries currently export to the FTA members. To make this summary discussion concrete, we first illustrate the various effects in terms of access to the EU market; we examine the corresponding effects in the Indian market later. As noted above, we assume that the tariffs faced by India in the EU are all set to zero by the FTA. This will have no direct effect for commodities in which both India and the excluded country concerned already face zero before the FTA, either because EU tariffs are already zero or because both India and the excluded country are both already exempted from a positive MFN tariff. A large number of commodities fall into this class, in fact. A second possibility is that the excluded country previously faced a zero tariff – because, say, it received 'Everything But Arms' (EBA) preferences – but India had a positive tariff which the FTA will reduce to zero. If India were efficient in this commodity, the tariff reduction would allow it to recapture a market that had previously been diverted to the excluded country – it would undo some trade diversion, a phenomenon which we call 'trade re-orientation'. Such events would be good for the EU, which now resumes buying from a more efficient source, but it entails a decline in the exports of the excluded country. This is potentially harmful, both through the loss of export revenue directly and the consequent deterioration in the terms of trade. Re-orientation of this kind is particularly a 'threat' to the ACP and least developed countries, because they mostly have very low-tariff access to the EU already.

The third possibility is trade diversion proper: if the excluded country and India both faced

the same positive tariff initially, the FTA would remove the tariff for India but leave it in place for the excluded country. Imports are potentially re-sourced from the excluded country to India and the EU pays more for its imports, thereby incurring a loss of economic welfare. The excluded country may also lose, although as we have just noted, falling exports do not necessarily imply harm. The countries for which this sort of outcome is a serious possibility are the BRICs – excluding India, of course.

Chapter 4 moves on to the effects of the FTA on prices that excluded countries might get for their exports – i.e. on their terms of trade. Driven by the decline in demand that trade diversion or re-orientation imply, excluded country firms may choose to reduce their export prices to the EU in order to attenuate the loss of competitiveness that they suffer. The important thing about this is that it concerns not just the marginal trade that is lost to diversion, but that the prices of all the units they sell in the EU are reduced. That is, it is larger the larger is the excluded country's trade with the EU. The competitive threat that excluded countries suffer on those exports is larger the greater the tariff cut that India receives in the EU (for fairly obvious reasons) and the larger the share of the EU market that India commands (because this makes it more likely that India influences the price in that market). We classify excluded countries' trade by these two criteria to try to assess how serious a threat this is.

Table 1 summarises some of the key results from these calculations. Block A deals with the EU market. The table considers three groups of countries: India's neighbours in South Asia, which are likely to be most similar to India in terms of exports; the BRICS (excluding India, of course) which are large players on the world stage and especially among developing countries; and groups of ACP countries, which are generally poor, small and heavily dependent on the EU market. The details of these calculations are given in Part II, but, briefly, they consider the percentage of each excluded country's *total* exports for which the FTA creates a competitive threat from Indian exporters, the average competitive advantage conferred on India through the removal of the tariffs on the goods exported by that country, and the share of total exports most vulnerable to terms of trade shocks. This last is the percentage of total exports accounted for by exports to the EU falling in headings for which India has a market share of 10 per cent or over and a current EU tariff on India of 5 per cent or over. These are the markets in which we expect to see the largest shocks to price behaviour.

The notable feature of Table 1 is the differences across countries. Thus fully 57 per cent of Bangladesh's exports (column A1) face increased competition from India, averaging up to 4 percentage points off Indian prices (column A2). Pakistan and Sri Lanka and to a lesser extent the Maldives and Nepal also have significant shares of vulnerable exports, as do the countries of Eastern and Southern Africa and SADC, although for the last two the tariff shock is smaller. These magnitudes are not disastrous, but they are potentially important. Outside these groups, on the other hand, the effects are small enough to ignore on average – shocks of 3 or 4 per cent of exports being well within normal bounds of variability. On the terms of trade (column A3), the shock looks relatively undramatic and evenly spread, except for the South Asian excluded countries, most notably Nepal, which has over a tenth of her exports in the vulnerable category. Of course, all

Table 1. Summary measures of export vulnerability to the EU–India FTA

	Block (A) the EU market			Block (B) the Indian market		
	1	2	3	1	2	3
	% of total exports suffering increased competition from India	Average tariff reduction for India on goods exported by the excluded country %	% of total trade relatively vulnerable to terms of trade pressures	% of total exports suffering increased competition from the EU	Average tariff reduction for EU on goods exported by the excluded country %	% of total trade relatively vulnerable to terms of trade pressures
Afghanistan	0.2	2.3	1.45	0.5	26.7	1.04
Bangladesh	56.8	4.1	1.13	0.6	24.4	0.07
Bhutan	0.0	3.4	0.00	57.5	18.1	9.96
Maldives	5.3	3.7	0.00	1.7	17.8	0.28
Nepal[7]	4.7	4.1	10.63	27.0	22.6	17.58
Pakistan	18.9	3.3	3.03	0.4	23.0	0.09
Sri Lanka	16.5	3.4	1.88	5.8	20.6	2.13
Brazil	2.3	2.3	0.01	0.4	16.3	0.13
Russia	0.5	2.1	0.00	0.4	14.9	0.28
China	4.0	2.3	0.16	3.8	18.0	0.30
South Africa	2.0	2.1	0.01	6.3	17.1	0.39
Caribbean	2.8	2.5	0.18	0.1	22.8	0.04
Central Africa	0.1	1.9	0.00	0.6	14.3	0.15
East and S. Africa	15.4	2.8	0.39	1.2	19.3	0.28
Pacific	0.5	2.3	0.00	3.4	22.6	0.02
SADC less S. Africa	1.5	2.7	0.00	0.9	19.0	0.03
West Africa	1.2	2.8	0.01	1.1	17.7	0.17

Sources:
column A1: Table II.4B (100-percentage incolumn 1)*column 5/100.
column A2: Table II.8.
column A3: Table II.16.
column B1: Table II.6B (100-percentage in column 1)*column 5/100.
column B2: Table II.12.
column B3: Table II.18.

these statistics refer to averages or aggregates, so even where the averages are low, specific markets or even firms may suffer major shocks.

We now consider access to the Indian market as India grants preferences to EU suppliers. The analysis is the same, but the story is quite different because Indian tariffs are generally high (column B2) and the EU's share of the Indian market is quite large. Thus assum-

ing that EU exports of a commodity to India are genuinely substitutable for an excluded developing country's exports in the same commodity heading, many countries will find that they suffer a serious reduction in sales and/or prices of exports to India. This is potentially harmful, but, in mitigation, the fact is that most countries export only a small share of their total exports to India, so that the impact on their total exports is still generally rather small (column B1). The main exceptions to this relatively relaxed view are those of India's South Asian neighbours that are heavily concentrated on the Indian market. They suffer a major shock to a major share of their trade. Nepal and Bhutan are landlocked and have trade agreements with India to facilitate their international trade; they will almost certainly require special treatment in the EU–India FTA. Sri Lanka faces similar, if smaller, challenges, again brought about or exacerbated by a previous FTA which leads it to focus heavily on the Indian market. Among other countries, only South Africa has a significant exposure.

Overall, the situation is that in neither the Indian nor the EU market will many non-South Asian countries suffer a material negative shock from the diversion or re-orientation of goods trade under an EU–India FTA. Particular sectors and the terms of trade for specific goods may suffer, however, and excluded countries may wish to monitor talks to identify such cases in advance, but they should not become unduly worried about their general market prospects. The situation for India's neighbours is more serious. They have significant shares of exports exposed in one or other of the two markets and in India may face a very significant increase in competition. (The doubt is whether EU and South Asian goods classified in the same HS-6 heading do really compete.) For them, it may be worth engaging the partners with a view to obtaining concessions to mitigate or compensate for the shocks or, for Bhutan and Nepal, to seek access to the FTA itself in the same way as they have access to India at present.

Part III shifts attention to services. Both India and the EU are major producers and exporters of services. An FTA that ignored services would miss the bulk of each economy and a material share of their international trade. Unfortunately, we have very little information about the barriers to services trade, and even the data on traded quantities are weak. Thus we cannot replicate the sort of analysis that we undertake for goods. We do discuss the nature of services trade by the partners and between them, and identify a number of sectors where serious liberalisation in the EU and/or India would be feasible. We also argue that the timing of liberalisation matters more for services than for goods because, especially in sectors with network economies or strong reputational aspects, incumbent firms have great advantages. Thus if India, say, offers EU firms preferential access to its market and then intends to extend that to other suppliers in a few years, this might still effectively deliver the market to the EU for very long periods of time. If the EU were not the most efficient producer, this could be harmful to India and to the excluded countries that would have captured the market in the absence of the preferences. Note, however, that because India's services markets are currently mostly fairly closed, few non-EU counties have large amounts of existing trade to lose, so the losses are relative to what would have been, not relative to where they are now.

We do believe that there will be some services content to the EU–India FTA and we conclude that although few excluded countries really have much to lose at present, they may want to monitor and try to influence the situation with a view to preserving options for future market penetration when the market is liberalised.

The final part of this publication deals briefly with policy responses – by individual excluded countries and by the multilateral system. With so many uncertainties about the FTA, and also about the extent of trade barriers and even trade in services, it is not sensible to identify specific sectors under threat. Moreover, even if one could, it is usually difficult to justify intervention to preserve them. Hence the advice is generic and general – but no less valid for that. Excluded countries need to react to the EU–India FTA with policies that would, even in its absence, boost their growth and economic flexibility. In addition, they may want to press the parties to keep them informed about negotiations and raise specific issues if details look particularly threatening; outside South Asia one should not expect wholesale losses of welfare as a result of the FTA, but within it, the stakes are material. These countries may wish to prepare to engage the partners over the difficulties they suffer and seek accession to the FTA or specific mitigating or compensating concessions. These may comprise asking the partners to extend the tariff preferences to them, relaxation of rules of origins, or aid to help meet EU standards or diversify into new markets. They might also indicate that they will seek to ensure that the WTO's rules on FTAs are enforced to the extent that they protect excluded countries' interests.

In the end, however, there is little that small poor excluded countries can do about an EU–India FTA acting individually, so they should also think about their systemic response. This poses a large dilemma. On the one hand, they may conclude that they should 'play the FTA game' harder themselves, negotiating access to deep and meaningful FTAs with the partners and anyone else in ways that reduce the discrimination they face and support their own reform programmes. This will require them to make concessions and will be expensive but it may, on balance, eliminate distortions in the world economy and result in greater market access and reform than the current situation.

On the other hand, they may reason that negotiating FTAs diverts attention and effort from the multilateral system and runs the danger that even small adverse effects will be replicated many times over as the trading system fragments. On this view, they may wish to oppose the process of creating FTAs in international fora, not in an instrumental way based on trade calculations of the sort we have performed here, but as a matter of principle and as a systemic issue which could eventually undermine the benefits of multilateralism which we currently tend to take for granted. Of course, in maintaining such a position, they would need to show a small amount of consistency and limit the extent to which they pursued FTAs themselves. Unfortunately there is not sufficient evidence to resolve the dilemma completely.

Notes

7 The inconsistency that Nepal has more exports vulnerable (column 3) to the FTA than affected (column 1) arises because we have had to use different years' data in the two exercises. It is a warning not to take precise numbers too seriously in exercises of this sort.

References

Gasiorek, M. et al. 'A Qualitative analysis of a potential Free Trade Agreement between the European Union and India' Study for DG Trade http://trade.ec.europa.eu/doclib/docs/2007/june/tradoc_135101.pdf

Part I

Background