Chapter 1

# Individual excluded countries

We first consider possible policy responses for individual excluded countries. The analysis above helps to identify broad sectors in which the shock from an EU–India FTA will be largest on average. Countries concentrated more heavily in these sectors are likely to experience greater competitive pressures and hence a greater need for adjustment. However, as pointed out previously, the shocks are mostly very small – quite within the limits of normal commercial uncertainty. Thus these data alone do not point to a need for specific policies but rather for sound conditions that allow firms to weather shocks. At lower levels of disaggregation there may be larger impacts, but again provided that firms can shift to closely related yet less affected products they will often be able to adjust relatively easily.

As we have just noted, the advent of the FTA does not change the case for good economic policy in general, but it might be felt to either raise the returns to better policy, or, more likely, relax the political constraints on it. In the face of an unprovoked policy-driven worsening in their external economic environment governments might fulminate against the injustice of the world, but they might also use the opportunity to galvanise public opinion towards self-help in terms of more demanding but more rewarding policy stances. Many successful reforms have been born of crisis – the realisation that things just cannot go on as they are. The EU–India FTA is not a crisis, but it will be a shock for certain countries or at least for sectors within them. We do not detail a policy cocktail for growth here – both the standard menu and the criticisms of standard menus per se are well-known – see for example The Growth Commission (2008) for a recent account and Easterly (2008) for a counter case. It includes policies such as:

- A relatively liberal international trade policy – for example low tariffs and other barriers to imports and exports, effective infrastructure and business services for international trade, a realistic exchange rate;
- A business climate that is conducive to investment and innovation – for example the appropriability and security of the returns to effort and risk-taking, accessible finance at reasonable rates of interest, reliable utilities. Some scholars – e.g. Rodrik (2007) – argue that governments should support experimentation and innovation by bearing the costs of any positive externalities that they generate, e.g. by offering start-up finance for new products or sectors, or underwriting certain borrowing. These are difficult policies to implement without their being captured by powerful interests, however, and so need considerable governmental capacity. They require a political system that allows enterprises to fail even if they have received public support and which firmly locates the objectives of public policy in social benefit via strong transparency and participation. Thus, while we accept the case in theory for

addressing industrial (or service sector) externalities, we caution the mostly small and poor members of the Commonwealth about the dangers inherent in such policies.

- Flexible labour markets: research suggests strongly that where labour markets are inflexible external shocks tend to be costly because, while the negative effects on uncompetitive sectors cannot be avoided, the opportunities for competitive sectors that come along with them cannot be exploited. Governments often fear that in these circumstances important objectives of social development will be compromised by resulting loss of employment. This is true, which should speak strongly to the need to relax labour market constraints, but even where frictions remain, the correct policies protect workers rather than jobs – i.e. governments should seek ways of maintaining access to basic services and a minimum income even if an individual's job is lost.
- Labour force quality is arguably an element of labour market flexibility, but independently it is a means to higher productivity and better lives in general. Thus education and health provision will enhance long-run growth prospects and probably those in the short run too as they allow a fairer distribution of the gains from growth.

The essential point about these policies is that the FTA does not change the nature of the case for pursuing them nor even very much the returns to doing so. What is required is just sound policy for its own sake.

Certain sectors in certain countries may be seriously affected by the EU-FTA, where tariffs in the partners are high and the trade flow is very sensitive to prices and competitiveness. Such sectors may seek government assistance to maintain their levels of activity, but unless their difficulties are clearly temporary, there is no case for such support – far better to just accommodate to the new circumstances by allowing these sectors to contract.[69] Even where a case can be made that the difficulties can be overcome by a limited period of support, the calculation needs to be made as to whether this is an optimal use of public monies and whether such support will really remain temporary.

Where the threatened trade flows are large enough to be important nationally, there may be even stronger demands for support, but again there is no case for satisfying them. There is nothing a small excluded country can do by itself to reverse the changes in its comparative advantage that an EU–India FTA might cause, so it is best off living with them and adjusting to them in a constructive way. An excluded country may, however, wish to take up with India or the EU the damage that it suffers from their activities and, if no solution is found, think about bringing a WTO dispute against the parties. Article 24 of the GATT and Article 5 of the GATS are not entirely unambiguous and there may be scope for redress. The articles, however, refer to the balance of the FTA across sectors, not sector by sector, so an excluded country would need to show damages at an aggregate level in order to prevail in a dispute.

It is better to identify possible problems in advance so that they can be raised with the partners during the negotiation phase rather than being brought to the table after they have struck all their difficult deals and achieved an acceptable balance. By that stage it is extraordinarily difficult for them to change tack for the sake of external interests. The current report helps to inform excluded countries of the broad parameters of the negotiation and its effects on them, but what they really need is much more detailed and private to the two parties. Possible responses would be to try to persuade India and the EU to brief their trading partners (privately), and also to maintain an intelligent watch on local discussion in India and the EU to identify pressures and requests that are being made. Such monitoring might be done collectively – even, say, by the Commonwealth Secretariat. Excluded country governments should keep their private sectors informed of developments and also encourage them to seek, through market contacts, indications of developments that might place them in jeopardy.

Excluded countries, especially the ACP countries, which have a special place in EU policy making, should seek to engage the EU in a discussion of the consequences of their FTAs for their welfare, and seek to obtain concessions for themselves to obviate the most serious of anticipated problems. The EU may well feel that for the sake of coherence it should listen to and act upon the legitimate concerns of such a group of their close partners. Of course, least developed and ACP countries already have fairly favourable access to the EU goods market, but in addition to seeking to complete their freedom of access, they may wish to seek concessions such as improvements in rules of origin, help with achieving and proving conformity to standards, better access to technologies for testing conformability or for producing and delivering exports.

One instrument to encourage such concessions may be for the excluded countries to offer further liberalisation of their own markets as a quid pro quo for EU concessions. In one sense, this will appear to be liberalising under duress, but given that import liberalisation is almost always beneficial to the liberalising country (Winters, 2004), this is not a helpful perspective. The ACP countries as a group probably do not have sufficient economic clout to prevent the EU–India FTA in a power-based negotiation, and a single ACP country will certainly not have. Thus the question for ACP countries is whether the FTA is better (less bad) for them with a negotiated concession or without. Given the relatively small sizes of the general effects, however, we suggest that attempts to negotiate redress should be concentrated on a few specific areas, rather than across the board.

One class of countries have a more direct response to the FTA – and a larger stake in it. These are India's two land-locked neighbours – Bhutan and Nepal – which have trade co-operation agreements with India and whose trading conditions are intimately connected to those of India. They appear to be heavily dependent on the Indian market and for Nepal to export to the EU goods that are seriously vulnerable to terms of trade shocks from India. (The doubt arises because there may be considerable confusion in the data about whether exports are to India or merely passing through to reach other markets or whether goods attributed to Nepal and Bhutan in the EU market do actually come from there. Clearly this is an area where further research may be desirable.) They would be heavily affected by attempts to enforce the EU–India FTA and should arguably seek access to it or special conditions to ensure that it does not impinge too heavily upon them.

## Note

69 If the FTA caused trade re-orientation, it corrected a previous distortion and world welfare is improved by its contraction. If the FTA caused trade diversion, world welfare is not enhanced by the contraction of the sector, but for the individual excluded country this is of less significance than the fact that it does not want to devote resources to protecting a sector the output of which no-one is willing to buy.