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Spice Route to Europe? Prospects for an India–EU Free Trade Area

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Summary

- Negotiations on an EU–India Free Trade Agreement (FTA) opened in June 2007. The EU and India are both pursuing a policy of bilateral trade agreements against a background of faltering multilateral negotiations.
- India still has a relatively low share of world trade – under 1% – of both goods exports and imports, and just over 2% of world services trade. The EU is the world's largest exporter and importer of both goods and services. It has a high, though falling, share of Indian goods imports and is an important provider of services and FDI for India.
- Indian barriers to trade, in goods and services, and to inward FDI remain high despite a general liberalization and very rapid fall in applied tariffs since 2004. The EU is relatively open but India will be anxious to improve market access for manufactures, services and FDI.
- For goods there is little overlap in trade structures or comparative advantage between India and the EU. Neither party is likely to press the other on agricultural liberalization – an area of extreme sensitivity for both in the Doha Development Agenda (DDA) negotiations. On services, both sides are anxious to increase their market access across all modes of provision, and negotiability is not an obvious problem
- Prospects for an agreement appear good but there are potential obstacles. These include general suspicion of trade liberalization in the Congress party across the country as well as other parties in the governing coalition; Indian lack of ambition for the agreement; the EU's requirement for environmental, social and human rights clauses in the agreements which might cause offence; the sheer complexity of the negotiations, which might mean they are overtaken by the next Indian general election campaign.

The policy context

Both the EU, as an entity and through its member states, and India are founding and active members of the World Trade Organization (and of its predecessor, the GATT). They are key players in the DDA negotiations. Both are prolific users of preferential agreements. Negotiations on an EU-India Free Trade Area opened on 28 June 2007.

The EU

Trade preferences have been a major tool of EU foreign economic policy since its inception. Currently about 70% of EU goods trade is on a preferential basis (WTO, 2007a) and includes agreements in place or under negotiation with the European Economic Area (EEA) and Switzerland; Turkey; the countries of the western Balkans; the African, Caribbean and Pacific group of countries; countries in the EU's neighbourhood in Eastern Europe and round the Mediterranean; the European Free Trade Association; the Gulf Cooperation Council; Mercosur; Mexico; Chile; and the Least Developed Countries (LDCs). There are also agreements under the Generalized System of Preferences (GSP). With the exception of the EEA and Switzerland, these existing agreements and negotiations have largely been restricted to trade in goods.

A new phase of EU trade policy emerged in 2006 with the publication of *Global Europe* (EU Commission, 2006). This set out a market access strategy (Rollo, 2006) aimed at the emerging trade powers' energy producers. It proposed using preferential trading agreements as the main tools and explicitly including services, investment and regulatory integration (collectively known as deep integration) as well the more traditional border barriers on goods. The target markets for this new policy are India, ASEAN, the Republic of Korea and Russia, as well as Mercosur and the Gulf Cooperation Council (GCC) states, where negotiations have long been under way with no signs of a breakthrough. As a result of this policy only the US, Japan and China, among the top trade powers, are not targets of EU bilateral agreements.

India

The key feature of Indian trade policy has been unilateral but unbound liberalization since 1991.¹ Average tariffs have fallen, from 80% in 1990 to 15% in 2005 (Table 1) and further to 12% in 2007. This has been accompanied by very significant domestic liberalization (dismantling of the 'Licence Raj') which has unleashed an enormous growth spurt in the Indian economy. This unilateral liberalization contrasts with extreme reluctance to commit to bound multilateral liberalization in either the

¹ Bound, unbound, binding and bindings are all terms of art for agreements in the WTO not to raise tariffs above the agreed (or bound) level (without giving compensation elsewhere). Countries can autonomously cut tariffs below the bound level but can raise these unbound (or applied) tariffs at any time up to the limit of the bound tariff. Negotiations in the WTO are about the level of bound tariffs.

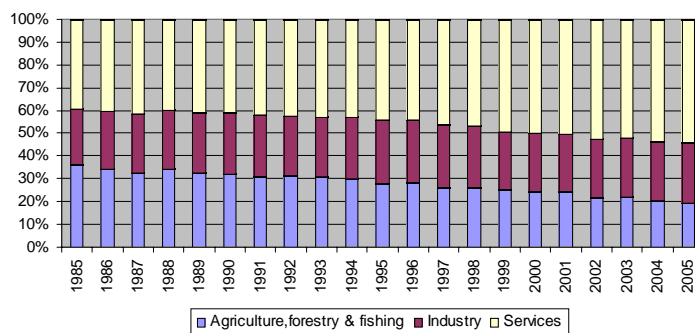
Uruguay Round or the DDA. Agriculture has been a sector of extreme sensitivity, as have the Singapore issues (competition policy, transparency in government procurement, investment rules and trade facilitation).

India has pursued a policy of bilateral and regional agreements with neighbours in South and Southeast Asia since 1975 (WTO, 2007b, 24: 28). These have typically been incomplete in trade coverage. India has more recently signed or is now pursuing agreements with a wider group of Asian countries and with developed countries. The 2005 agreement with Singapore is seen by many Indian commentators as the most ambitious so far and as the likely model for future FTAs. But even this agreement has substantial exclusions in agriculture, manufactures and services. Potential partners for future agreements include Japan and China as well as the EU.

Bilateral trade performance and structure

Figures 1 and 2 reveal the key importance of the services sector to the development of the Indian economy and trade. Unlike other major developing economies, India is moving resources directly from agriculture to services, rather than seeing the manufacturing sector first become the engine of domestic and export growth. This is based on the unusually high availability of tertiary-educated labour for a developing country. However, there is a considerable surplus of under-educated, unskilled and

FIGURE 1: EVOLUTION OF THE STRUCTURE OF THE INDIAN ECONOMY



This figure and all subsequent tables and figures are taken from Gasiorek et al. (2007).

FIGURE 2: STELLAR GROWTH OF INDIAN SERVICES EXPORTS

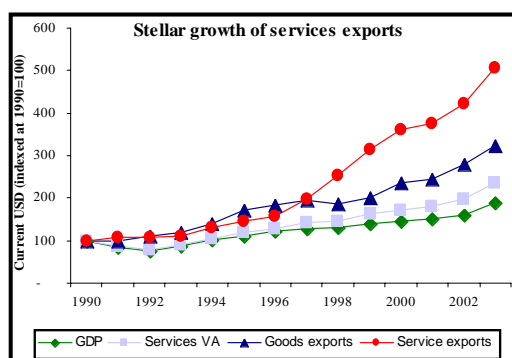


TABLE 1: INDIAN AND EU TARIFFS (%)

	Indian tariff			EU tariff
	1990	2005	% fall	2005
Total trade	78.9	16.0	79.8	4.97
Food and live animals	55.1	36.9	33.2	8.5
Beverages and tobacco	251.8	98.0	61.1	16.04
Crude materials, except fuels	62.6	15.0	76.1	0.84
Mineral fuels etc.	45.5	14.4	68.4	1.46
Animal and vegetable oils	109.0	48.0	56.0	4.76
Chemicals & related	81.5	15.7	80.8	4.5
Manufactured goods	82.7	15.4	81.4	4.16
Machinery & transport equipment	76.4	13.8	81.9	2.21
Miscellaneous manufactures	79.2	13.9	82.5	5.89
Commodities n.e.s.	87.1	16.7	80.8	1.34

TABLE 2: INDIAN TRADE OPENNESS

Country	Imports of goods & services as % of GDP		Exports of goods & services as % of GDP			
	2000	2004	Growth	2000	2004	Growth
Brazil	12	13	8.3	11	18	63.6
China	21	31	47.6	23	34	47.8
High income	24	23	-4.2	24	22	-8.3
India	14	21	50.0	13	19	46.2
Low income	21	26	23.8	19	24	26.3
Middle income	29	32	10.3	30	35	16.7

underemployed labour that will require absorption into the formal economy if India's very real poverty problem is to be tackled. Literacy levels below 70% (compared with Chinese figures above 90%) reveal a real barrier to a more traditional manufacturing export-led growth strategy. After more than 15 years of economic reform Indian trade openness is approaching High Income Country levels (Table 2).

India's trade in goods is under 1% of world totals, whereas the EU's is around 18%. Over 20% of India's imports and exports of goods are from and to the EU (Figures 3 and 4). The EU is India's largest, albeit declining, trade partner. India provides about 1.5% of the EU's imports and exports. India's share of world services trade is over 2% and the EU's around 25%. Bilateral trade flow data on services are less available but the EU is a target market for Indian exports of high value added services (Figure 5).

The structure of Indian exports of goods is very unlike that of the EU and other developing-country exporters, notably China and Southeast Asia (Table 3), with only a 20% overlap. Similarly the pattern of Indian comparative advantage in goods is quite different from that of the EU (Gasiorek et al., 2007: 18). India shows some development in intra-industry trade, particularly in vertically integrated trade, which suggests that it is integrating into global supply chains, but the EU is not a major partner in this type of trade. The structure of EU exports to India is relatively similar to that of other major exporters (about 50% overlap – Gasiorek et al., 2007: 19). This, combined with high average tariffs and individual tariffs that are way above the average (tariff peaks) would give the EU very substantial preferential advantage in the Indian market and help it displace more efficient competitors (called trade diversion in the economics literature) to the economic disadvantage of India.

FIGURE 3: SHARE OF INDIAN IMPORTS BY SOURCE

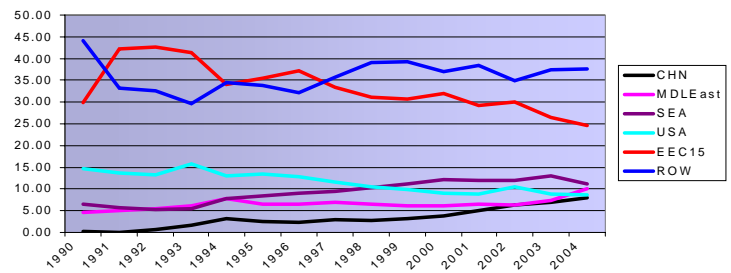


FIGURE 4: INDIAN EXPORT SHARES BY DESTINATION

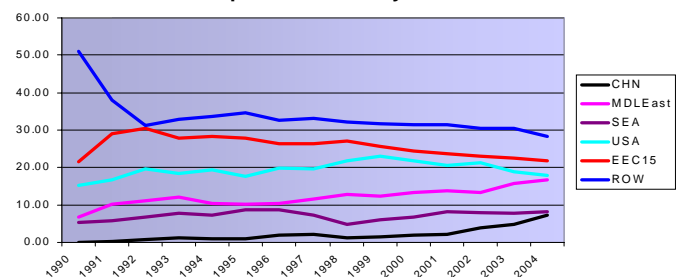
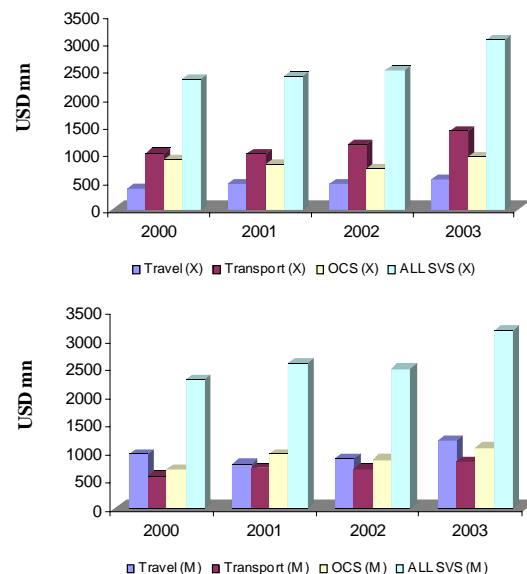


FIGURE 5: INDIAN SERVICES EXPORTS TO AND IMPORTS FROM THE EU15



Barriers to trade

As Table 1 shows, India's applied tariffs have been falling (and have fallen further in 2007 towards an average of 12%) but remain significantly above the EU's levels. Tariff peaks remain very high in India, reaching 100% or more. Despite the EU's low average tariff there are peaks in the 10–20% range that confront Indian exports. Indian non-tariff barriers are estimated at around 18% on average. These NTBs appear to affect a significant proportion of the EU's exports, raising the total protection level to over 30% (Gasiorek et al., 2007: 22).

TABLE 3: EXPORT SIMILARITY INDEX

	India	EU	China	USA	SEA
India	1				
EU	0.24	1			
China	0.25	0.36	1		
USA	0.2	0.6		1	
SEA	0.21		0.42		1

India's commitments under the WTO services agreements are limited, covering about 10% of trade, and foreign direct investment (FDI) caps in services are bound at 10%. As in goods, unilateral liberalization has raised the level of foreign engagement in the services sector but significant barriers remain. The EU will, in particular, be looking to raise or abolish investment caps in the financial services sector. EU barriers to services are relatively low but as the controversy over domestic services market liberalization has shown, liberalizing the movement of persons is likely to be difficult. There are also issues over the recognition of qualifications on both sides that stand in the way of trade in professional services, notably in legal and accountancy services.

On FDI, both sides find it difficult to deal with differential regimes at member state and state level in the EU and India respectively. Although EU procurement rules are relatively clear, there is a lack of transparency about India's central and state government procurement rules and outside information and technology (ITC) products there is little if any Indian procurement from foreign firms. There are also procedural and infrastructure barriers to trade at Indian ports and internal barriers to interstate commerce.

Negotiability of an EU-India FTA and the prospects for agreement

The relative lack of overlap in export structures and comparative advantage, strong mutual interest in market access for services and FDI, and a common interest in low levels of liberalization in agricultural trade suggest that this negotiation could be easier to complete than others on the EU's list. The prior discussion in a High Level Official Group may also mean that there is significant

common ground at the outset on objectives and both sides claim to want an ambitious agreement. The fact that Indian officials have tied an EU FTA to the domestic reform process – implicitly a form of external binding of the reforms – also gives some reasons for optimism on the part of negotiators. However, significant potential blockages remain.

(1) Outside the Indian government there is significant suspicion of trade liberalization. Indian stasis in the DDA is one symptom of this. To a degree this is driven by resistance to agricultural liberalization as a threat to the livelihoods of the rural poor, so the EU's likely mutual lack of interest in liberalizing this sector in an FTA may help.

(2) India was also a prime opponent of including the so-called Singapore issues (see above), and these will be core components of any EU request in an FTA negotiation.

(3) The Congress party in the country as a whole, and Sonia Ghandi in particular, are nervous of more liberalization as the next election approaches. Other members of the ruling parliamentary coalition are ideologically opposed to trade liberalization. So the support for the government on this issue in the Indian parliament may be weak.

(4) The Indian side may well take offence at the EU insistence on including environmental, social and human rights clauses in any agreement. They might reasonably fear that these have protectionist intent or simply consider them patronizing to a country that has a democracy older than that of many EU member states.

(5) The EU side will want to go beyond the India-Singapore FTA that many in India seem to see as the model for an EU agreement. It will be hard for the EU negotiators to take a draft agreement that does not offer significant preferential market opening back to Brussels for approval by the member states.

(6) Despite a mutual commitment to a rapid agreement, the sheer complexity of the negotiations may mean they are not completed by the time of the next Indian elections. They may get held up and perhaps repudiated by any new government.

References

EU Commission (2006), *Global Europe*,

http://ec.europa.eu/trade/issues/sectoral/competitiveness/global_europe_en.htm.

Gasiorek, M. et al. (2007), *Qualitative Analysis of a Potential Free Trade Agreement between the European Union and India*, Report for the EU Commission, Main Report:

http://trade.ec.europa.eu/doclib/docs/2007/june/tradoc_135101.pdf

and Annexes:

Annex 1 (from which tables and figures in this briefing paper are taken):

http://trade.ec.europa.eu/doclib/docs/2007/july/tradoc_135346.pdf;

Annex 2: http://trade.ec.europa.eu/doclib/docs/2007/july/tradoc_135347.pdf;

Annex 3: http://trade.ec.europa.eu/doclib/docs/2007/july/tradoc_135348.pdf;

Annex 4: http://trade.ec.europa.eu/doclib/docs/2007/july/tradoc_135349.pdf.

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