Weekly Focus

VISIONIAS
INSPIRING INNOVATION

India and FTAs

Introduction

Recently, the Regional Comprehensive Economic Partnership (RCEP) was finally signed with participation of 15 members including 10 ASEAN member countries and Australia, China, Korea, Japan and New Zealand, after over a decade of negotiations. While it is being described as the world's largest free trading agreement, India had decided against joining RCEP last year citing several concerns.

Alongside this major development, the world governments are increasingly resetting their approach to trade agreements in the midst of the coronavirus pandemic. Consequently, there have been debates as to whether there is a need to rejig India's trade relations with the rest of the world by overhauling its Free Trade Agreement (FTA) strategy. In this context, it is pivotal to understand what FTAs are and why are they important? What significance do they hold for India in the present Global Scenario? What has been India's experience with FTAs in the past? Why are FTAs not working as expected for India? What are the steps taken by India to strengthen its existing FTAs? And moving forward, what should be India's approach towards FTAs? In this edition we will attempt to answer these questions.

What are Free Trade Agreements (FTAs) and why are they important?

FTAs are arrangements between two or more countries or trading blocs that primarily **agree to reduce or eliminate customs tariff and nontariff barriers** on substantial trade between them.

- There are several variants of FTAs like PTAs, CEPA or CECA. But following can be cited as key features of FTAs-
  - In FTAs, member countries specifically **identify the duties and tariffs that are to be imposed on member countries** when it comes to imports and exports.
  - FTAs **normally cover trade in goods** (such as agricultural or industrial products) or **trade in services** (such as banking, construction, trading etc.), **but can also cover other areas** such as intellectual property rights (IPRs), investment, government procurement and competition policy etc.
  - FTAs also generally **provide a criteria** known as the 'Rules of Origin (RoO)' that are **needed to determine the country of origin** of a product for purposes of international trade (for imposition of preferential tariff). These RoO are enforced by issuance of a Certificate of Origin (CoO) by authorized agencies of the trading partner.
  - FTAs act as an **exception to the Most Favoured Nation principle** adopted by WTO.
- FTAs play an integral role in globalization and free trade in the following ways:
  - **Creating a more Dynamic Business Climate:** Free trade encourages competition on a global level, which consequently leads to increase in a efficiency of domestic industries, cheaper and better-quality products for consumers and increases specialization within countries.
  - **Abolition of global monopolies:** With elimination of tariffs and quotas, global monopolies are eliminated due to increased competition.
  - **Promote regional economic integration and global economic growth:** FTAs help build shared approaches to trade and investment and provide support for stronger people-to-people and business-to-business links thus enhancing global growth.

How are FTAs different from other trading agreements such as the PTA and CECA/CEPA?

- **Preferential Trade Agreement (PTA): Compared to a PTA, FTAs are generally more ambitious in coverage of tariff lines (products)** on which duty is to be reduced. For example- in a PTA there is a positive list of products on which duty is to be reduced; in an FTA there is a negative list on which duty is not reduced or eliminated.
- **Comprehensive Economic Cooperation Agreement (CECA) and Comprehensive Economic Partnership Agreement (CEPA):** FTA is different from these on two counts-
  - Firstly, **CECA/CEPA are more comprehensive and ambitious than an FTA in terms of coverage of areas and the type of commitments.** While a traditional FTA focuses mainly on goods; a CECA/CEPA covers many areas like services, investment, competition, government procurement, disputes etc.
  - Secondly, **CECA/CEPA looks deeper at the regulatory aspects of trade than an FTA** and encompasses mutual recognition agreements (MRAs) that cover the regulatory regimes of the partners.

What is the relationship between Most Favored Nation (MFN) principle and FTAs?

- Article 1 of GATT (General Agreement on Tariffs and Trade) which enunciates the **MFN principle of WTO** prohibits member countries to discriminate between their trading partners and states that if a country grants some nation a special favour (such as a lower customs duty rate for one of their products),it has to do the same for all other WTO members.
- However, **derogations from this MFN principle are permitted for forming FTAs under specific conditions such as-**
  - FTA members shall not erect higher or more restrictive tariff or non-tariff barriers on trade with non-members.
  - Elimination of tariffs and other trade restrictions should be applied to "substantially all the trade between the constituent territories in products originating in such territories."
  - Elimination of duties and other trade restrictions on trade within the FTA to be accomplished within a reasonable length of time (no longer than 10 years).

What significance do free trade/FTAs hold for India in the present global scenario?

Proponents of an isolationist or protectionist approach in trade often advocate for an inward orientation on trade that focuses on domestic demand for economic growth based on factors such as large and dynamic nature of India's domestic market, low impact of exports in general and exports of manufactures in particular on India's overall economic performance and poor export prospects in the post COVID world due to rise in protectionist tendencies and adverse impact on global supply chains.

However, **FTAs assume special importance for India** due to the following reasons-

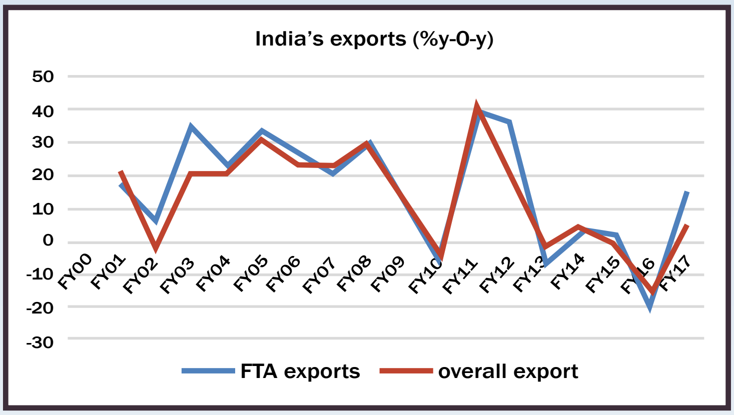
- **India's real market size is not sufficiently big:** India has a large population of people who don't consume middle-class goods; while the smaller group of high earners have high saving rates, reducing their consumption.
- **Exports have been a crucial component of India's growth:** Despite unfavourable global conditions over the past decade, India's export to GDP ratio remains a substantial 20 percent in 2018, more than twice as high as in the early 1990s.
  - This has significant consequences for India's growth outlook. For example, if export growth slows by 5 percentage points, this will shave 1 percent in overall GDP growth.
- **Opportunities in a post COVID world:**
  - Structural changes like rise in remote learning, work from home etc. could actually boost demand for tradable services for India.
  - Even if overall global imports of goods grow slowly, India is small enough to gain market share, thereby maintaining high rates of export growth.
  - There is enormous potential to increase unskilled labor based exports in India, especially in sectors where China is rapidly ceding space, like: apparel, clothing, leather, and footwear.
- **Connecting India with Global Value Chains (GVCs):** FTAs have the potential to accelerate economic integration among countries thus making India a vital cog in the Global Supply Chain.

What has been India's experience with FTAs?

India's initial engagement with FTAs was **coincidental with systemic opening of the Indian Economy** in the 1990s. The primary objective of an FTA arrangement was to **generate more trade and investment opportunities for the country.** The initial efforts led to signing of **India's first FTA with Sri Lanka in 1998.**

India's other major FTAs include **India ASEAN Trade in Goods Agreement,** South Asia Free Trade Agreement **(SAFTA), India Korea CEPA, Japan India CEPA, India Singapore CECA, Indo Malaysia CECA** etc. India is also engaged in several other negotiations with Canada, Australia, BIMSTEC countries, European Union etc. Following trends have been observed after analyzing the impacts of these FTAs-

- **Increase in exports:** The overall increase in India's exports to the partners, with which the agreements have been signed, is 13.4 percent for manufactured products and 10.9 percent for total merchandise from the year 1993 to 2018.
  - Although, there has been a significant increase in exports to FTA partners, this growth cannot be completely attributed to the FTA as the export trends for partners and non-partners are almost similar.



- **Substantial gains from SAFTA:** Since the SAFTA became effective (in 2006), Indian exports to SAFTA countries have increased faster than its imports from them leading to a significant rise in trade surplus with these economies from about US$ 4 billion (in 2005-06) to US$ 21 billion (in 2018-19).
    - The maximum growth in exports to SAFTA region has been recorded with Bangladesh and Nepal.
- **Rise in trade deficits with ASEAN, South Korea and Japan post FTAs:** Imports from these FTA partners into India increased more than India's exports to these partner countries post signing of FTAs. For example-
    - The faster growth in imports from ASEAN has resulted in a significant increase in India's trade deficit with it, from less than US$ 8 billion in 2009-10 to about US$ 22 billion in 2018-19. The share of ASEAN in India's total trade deficit has increased from about 7% to 12% during the same period.
- **Low utilization of FTAs:** According to the Asian Development Bank, the utilization rate (percentage of trade which is conducted through preferential route) of India's FTAs varies between 5% and 25%, which is one of the lowest in Asia.
- **Limited export growth in Value added sectors:** Growth in India's exports to its partner countries in value added sectors have been grim. For example- **Under India ASEAN FTA,** trade balance has worsened (deficit increased or surplus reduced) for 13 out of 21 sectors in which tariff were reduced. These sectors are mainly value-added sectors like - chemicals and allied sectors, plastics and rubber, minerals, leather, textiles, gems and jewelry etc.

These observations reflect the performance of FTAs for India. But it should be noted that FTA performance does not reflect India's trade performance as **India's FTA and bilateral trade agreement partners add only up to 15 per cent of its total global trade by value.**

India and Regional Comprehensive Economic Partnership (RCEP)

The Regional Comprehensive Economic Partnership (RCEP) is the **world's largest trade bloc** of 15 countries including the 10 ASEAN members, China, Japan, South Korea, Australia and New Zealand. In 2019, India decided to distance itself from the RCEP negotiations.

Why did India pull out of RCEP?

- **Trade imbalance with RCEP members:** India's trade deficit with RCEP countries has almost doubled in the last five-six years - from $54 billion in 2013-14 to $105 billion in 2018-19, where trade deficit with China alone accounted for $53 billion.
- **Geopolitical considerations:** India wanted RCEP to exclude most-favored nation (MFN) obligations from the investment chapter, as it did not want to hand out, especially to countries with which it has border disputes (China), the benefits it was giving to strategic allies or for geopolitical reasons.
- **Security considerations:** Closer economic ties under RCEP have the potential to make the countries of the region even more vulnerable to China's economic and political coercion. This could impact India's security interests in Southeast Asia.
- **Inadequate protection against import surge:** Lack of strong protection measures can lead to flooding of Indian markets with products that have been subsidized and emerge from countries with unfair production advantages.
- **Lack of Service component:** India's comparative advantage lies in adjusting the trade deficit in goods by counterbalancing it with services trade. However, most developed RCEP countries where India can export services, have been unwilling to negotiate wide-ranging disciplines in services that can create new market access for trade in services in this region.

INDIA'S TRADE BALANCE WITH RCEP MEMBERS

RCEP Member	2018-19	2019-20
ASEAN	-21.85	-23.82
China	-53.58	-48.65
South Korea	-12.05	-10.81
Japan	-7.91	-7.91
New Zealand	-0.25	-0.14
Australia	-9.61	-6.93

All figures in $ billion

Source: Ministry of Commerce and Industry

- **Apprehensions from local industries:** A large number of sectors including dairy, agriculture, steel, plastics, copper, aluminium, machine tools, paper, automobiles, chemicals and others had expressed serious apprehensions on RCEP citing that dominance of cheap foreign goods would dampen their businesses.

- **Other reasons** include:
  - Differences over tariff structure with China on goods.
  - Lack of credible assurances on market access, non-tariff barriers and restriction on circumvention of rules of origin.
  - India already has bilateral FTAs with ASEAN, Korea and Japan and negotiations are underway with Australia and New Zealand.
  - The e-commerce chapter has some clauses that affect data localization norms in India.

Why are FTAs not working as expected for India?

The cumulative effect of several factors has held India back from gaining substantially from its existing FTAs. Some of these factors have been stated below:

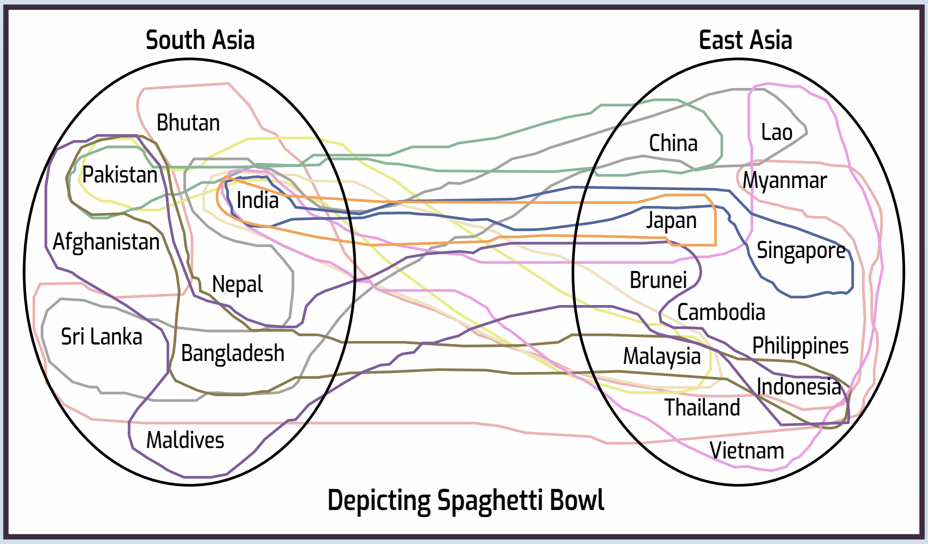
- **Asymmetrical tariff commitment:** While India's obligation under the WTO was to remove tariffs on just 2 per cent imports, tariff cuts it offered in its FTAs was in the range of 74 percent to 86 percent. This has not turned out feasible for India since it stands at a disadvantage with nations like Japan and Singapore in terms of industrial development and capacity of local industries to compete on global platforms.
- **Non-tariff barriers:** While FTAs removed tariff barriers substantially, Indian exporters still face a variety of nontariff barriers like import controls, import permits, sanitary and phyto-sanitary measures, product standards and technical barriers in partner countries.
  - For example- 76 per cent products exported to Japan face some non-tariff regulation.
- **Lack of Ease of trading:** Lack of information on FTAs, complex rules of origin criteria, low margins of preference, higher compliance costs and administrative delays dissuade exporters from using preferential routes.
- **Absence of services component:** Services is considered as India's strong area but its performance under FTAs is hampered due to absence of mutual recognition agreements (MRAs), which allow qualified personnel in one region to automatically qualify for offering services in any partner country.
- **Domestic factors:** Exporters in India face issues such as higher logistics costs, supply-side constraints like energy shortages etc., dampening price responsiveness of exports making them less competitive in the global market.
  - The Economic Survey 2017-18 points out that a 10% decrease in indirect logistics cost can contribute to around 5-8% increase in exports.
- **Circumvention of rules of origin:** Authorities in India have not been effective in checking illegitimate practices such as re-routing of imports from non-FTA partner countries through FTA partner countries, manipulative measures to obtain Certificate of Origins (CoO) etc.
  - For example- In case of India- SriLanka FTA, Sri Lanka had started exporting copper to India by under invoicing of imported scrap in order to show higher value addition for qualifying for preferential rates under the FTA.
- **Global perception of India being protectionist:** Several Indian policies in the recent times have pointed towards a potentially inward orientation on trade. These include- PM Modi's call for self-reliance under Atmanirbhar Abhiyan, putting free trade agreements on hold, revised public procurement order giving preference to local content etc. This perception directly affects the FTA negotiations with prospective partner nations and also indirectly clouds the current trading arrangements.

Does Atmanirbhar Bharat mean a new era of protectionism?

Although the idea of self-reliance and associated measures are reminiscent of the erstwhile protectionist era but the Prime Minister in his address has clarified that **India's self-reliance does not advocate self-centric arrangements.**

It is imperative to understand that self-reliance **does not imply embracing isolationist policies or blanket protectionism.** It rather focuses on deeper **integration with regional and global value chains and** can help revive **manufacturing growth in India** and also prepare these sectors to be globally competitive in export markets.

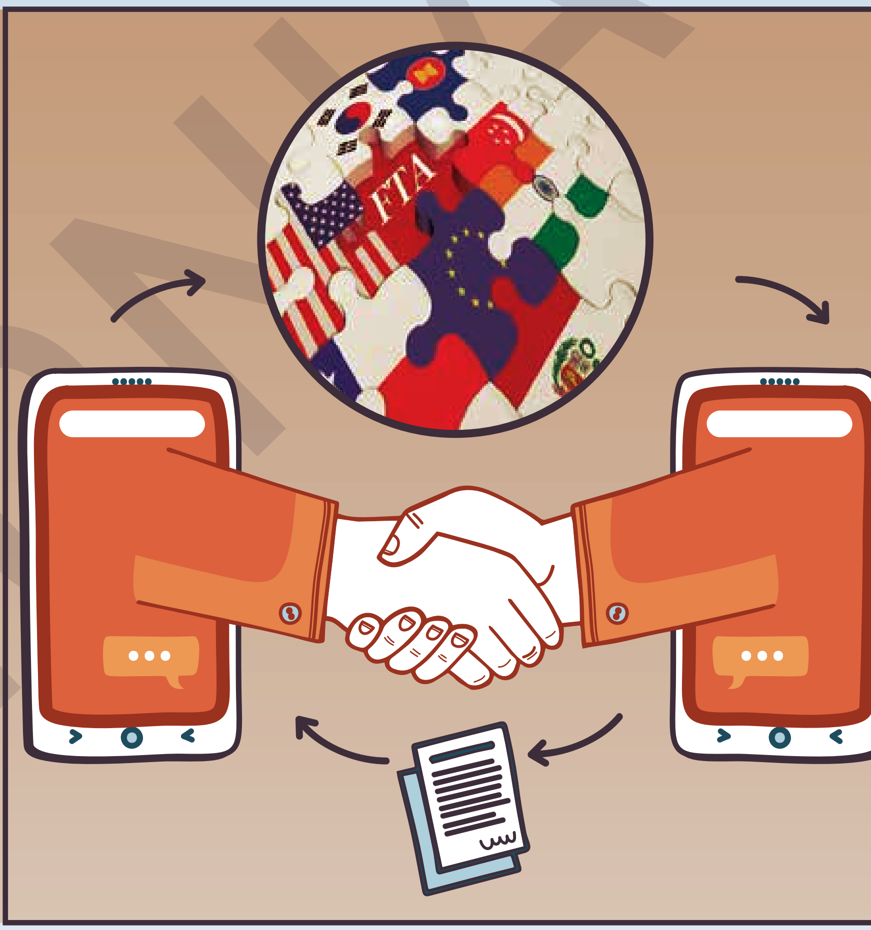
- **Spaghetti bowl effect:** The concept highlights that increasing number of overlapping FTAs between countries can lead to inconsistencies which in turn slows down trade relations between them. For example, India has an FTA with Malaysia and Singapore separately while they are also a member of India ASEAN CECA.
- **Slow pace of negotiations:** While countries like Vietnam have been successful in signing an FTA with the EU, negotiations for a comprehensive FTA between the EU and India are ongoing since 2007 without substantial progress.



Depicting Spaghetti Bowl

What are the steps taken by India to strengthen its existing FTAs?

- **Strengthening RoO mechanism:** Keeping in mind the dumping of imports through FTA partner countries and re-routing of imports from non-FTA partner countries through FTA partner countries, the Ministry of Finance recently announced **the Customs (Administration of Rules of Origin under Trade Agreements) Rules, 2020 (CAROTAR 2020)** to tighten the enforcement of RoO norms under Free Trade Agreements.
  - CAROTAR 2020 has now made it incumbent on the importer **to collect sufficient information/documents to convince the authorities that rules of origin criteria for the imports have been met** in order to get preferential tariff. Also, the claim of preferential rate of duty may be denied in case of any irregularities.



- **Revision of Bilateral Investment Treaties (BITs):** In 2015, India decided to review all of its existing BITs and released a Model BIT in 2016. The revised model BIT will be used for re-negotiation of existing investment chapters in CECAs/ CEPAs / FTAs and negotiation of future BITs.
  - The essential features of the model BIT include an "enterprise" based definition of investment, non-discriminatory treatment through due process, national treatment, **a refined Investor State Dispute Settlement (ISDS)** provision requiring investors to exhaust local remedies before commencing international arbitration and limiting the power of the tribunal to awarding monetary compensation alone.
- **Reviewing existing FTAs:** In a meeting held in 2019, in Thailand, India and the ASEAN decided to initiate the review of the ASEAN-India Trade in Goods Agreement that has been in operation since January 2010.
  - The main objective of the proposed review is to make the agreement more 'user-friendly, simple, and trade facilitative for businesses' and it hopes to address India's concerns over rising trade deficits with the ASEAN members.

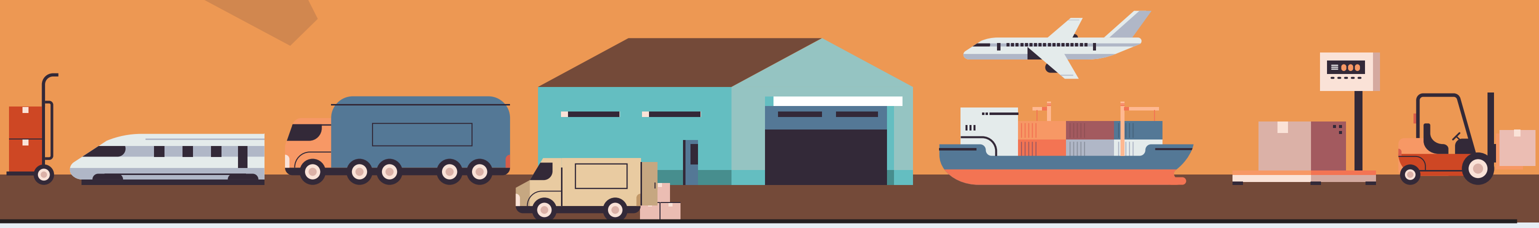
Moving forward, what should be India's approach towards FTAs?

For the Indian industry to grow and become globally competitive, integration into the global value chain is imperative, it is also crucial to formulate FTAs in a manner that helps India achieve its strategic and economic goals in a sustainable manner. Steps that can be taken in this direction are-

- **Strong safeguard clauses within existing/future FTAs:** Safeguard clauses need to be designed in a way that the **domestic industry gets protection** in case of material injury well within time. Within the FTA, provision could be made for safeguard measures to be invoked if a volume or price trigger for the concerned products is reached.
- **Participating in Confidence building measures:** Prior to signing a new FTA, India can test its capabilities using Early Harvest Scheme/Programme (EHS). EHS scheme is a precursor to a free trade agreement (FTA) between two trading partners. This is to help the two trading countries identify certain products for tariff liberalisation pending the conclusion of FTA negotiation.
- **Aligning future FTA negotiation strategy/tariff schedules with the Atmanirbhar Bharat strategy:** This does not imply complete protection for these industries, but a phase-wise reduction of import tariffs over years under the FTA in order for them to **completely integrate with global value chains (GVCs).**
- **Building new relationships in Post-COVID world order:** The post-COVID world trade order will most likely be influenced by geo-political decisions. This gives India an opportunity to leverage its geopolitical relations to create economic relations via creation of newer FTAs and also revision of its existing FTAs.
  - For instance, many countries are now wary of China and may strategically align themselves with other trade partners for diversifying global supply chains. India has an opportunity here and can potentially fill this void by scaling up its champion sectors.
- **Pick and choose partners carefully:** India should focus on negotiating bilateral FTAs with countries where trade complementarities and margin of preference are high and will benefit India in the long run. For example, India can find more opportunities in markets like the US, EU etc where it already has a bigger presence, if trade pacts facilitate better market access.
- **Making trade through FTA routes easier:** Measures that can be taken to **enhance the utilization rate of preferential exports,** include-
  - **Conducting awareness outreaches** across the country about FTAs
  - **Reducing compliance cost and administrative delays** in obtaining CoO.
  - **A low level of service link costs** i.e. costs related to transportation, communication, and other tasks involved in coordinating the activity between partner countries.

Conclusion

The current regional and global trade dynamics collectively make a strong economic and strategic case for India to relook at its FTA policy afresh and comprehensively, keeping India's investment and industrial policies in mind. India should also utilize the time-out from RCEP negotiations to carefully examine the lessons learnt from the existing free-trade agreements.



TOPIC AT A GLANCE

Free Trade Agreements (FTAs)

- **Definition:** Arrangements between two or more countries or trading blocs that primarily **agree to reduce or eliminate customs tariff and nontariff barriers** on substantial trade between them.
- **India's major FTAs:** India ASEAN Trade in Goods Agreement, South Asia Free Trade Agreement (SAFTA), India Korea CEPA, Japan India CEPA etc.
- **Importance of FTAs**
  - **Creating a more Dynamic Business Climate** by encouraging competition on a global level.
  - **Abolition of global monopolies.**
  - Promotes **regional economic integration and global economic growth.**

Significance of FTAs for India

- **India's real market size is not sufficiently big** to support domestic demand led economic growth and **exports have been a crucial component of India's growth**.
- **Post COVID world presents several Opportunities for India:** Structural changes could boost demand for tradable services from India; India is small enough to gain market share even if overall global imports of goods grow slowly; Enormous potential in India to increase unskilled labor exports.
- **Connecting India with Global Value Chains (GVCs).**

India's experience with FTAs

- **Overall increase in India's exports** to the partners.
- **Gains from SAFTA** with significant rise in trade surplus with SAFTA countries.
- **Substantial rise in trade deficits with ASEAN, South Korea and Japan post FTAs.**
- **Low utilization** of FTAs and **limited export growth in Value added sectors.**
- **Withdrawal from RCEP negotiations** due to reasons such as trade imbalance with RCEP members, Geopolitical and Security considerations, inadequate protection against import surge, apprehensions from local industries etc.

Why are FTAs not working as expected for India?

- **Asymmetrical and unfavorable tariff commitment.**
- **Non-tariff barriers in partner countries** like import controls, sanitary and phyto-sanitary measures, etc.
- **Lack of Ease of trading through FTA routes:** due to factors such as complex rules of origin criteria, higher compliance costs and administrative delays etc.
- **Absence of services component .**
- **Domestic factors constraining export growth** such as higher logistics costs, supply-side constraints like energy shortages etc.
- **Circumvention of rules of origin.**
- **Global perception of India being protectionist.**
- **Spaghetti bowl effect** (overlapping FTAs between countries creating inconsistencies).
- **Slow pace of negotiations.**

Steps taken by India

- **Strengthening RoO mechanism:** Notified the Customs (Administration of Rules of Origin under Trade Agreements) Rules, 2020.
- **Revision of Bilateral Investment Treaties (BITs):** In 2015, India decided to review all of its existing BITs and released a Model BIT in 2016.
- **Reviewing existing FTAs:** In 2019, India and the ASEAN decided to initiate the review of the ASEAN-India Trade in Goods Agreement.

Suggested approach for strengthening FTAs

- **Strong safeguard clauses within existing/future FTAs.**
- **Participating in Confidence building measures** using Early Harvest Scheme/Programme (EHS).
- **Aligning future FTA negotiation strategy/tariff schedules with the Atmanirbhar Bharat strategy.**
- **Building new relationships in Post-COVID world order** by leveraging its geopolitical relations.
- **Pick and choose partners where** trade complementarities and margin of preference are high.
- **Making trade through FTA routes easier** by conducting awareness outreaches, reducing compliance cost and administrative delays etc.