INNOCENT BYSTANDERS

Implications of an EU–India Free Trade Agreement for Excluded Countries

L Alan Winters and others, Centre for the Analysis of Regional Integration at Sussex

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Preface

This publication comes out of a request from the Commonwealth Secretariat in London under the Commonwealth Fund for Technical Co-operation. The terms of reference of the request were for us to assess the implications of a potential EU–India bilateral trade deal on other developing countries, particularly for the African, Caribbean and Pacific (ACP) and other low-income developing countries that have an overwhelming dependence on the EU market for their export revenues.

The specific tasks to be undertaken were as follows. First, we were asked to review the existing literature on regional trading arrangements and their implications for the excluded countries, to review EU bilateral strategy and EU–India FTA in the broad context of EU trade and commercial policies, and to analyse trade patterns and trends and, thus, to identify the sectors in which trade flows between the EU and India are likely to be expanded as a result of the implementation of any FTA deal. These matters are dealt with in Part I: Background.

The next set of tasks related to excluded countries and the market for goods, and are dealt with in Part II. The tasks were to compare ACP countries' trade and tariff structure with the EU vis-à-vis those of India's so as to assess the potential implications for ACP countries' competitiveness; to analyse the likely trade implications for South Asian countries such as Bangladesh, Bhutan, Nepal, Sri Lanka and Pakistan that have either bilateral free-trade arrangements (e.g. Indo-Sri Lanka, Indo-Nepal and Indo-Bhutan bilateral FTAs) or regional free trade deals with India (e.g. the South Asian Free Trade Area involving all the countries named above); and to provide a brief assessment of potential trade implications for other relatively advanced developing countries such as Brazil, China, and other East Asian newly industrialising countries.

Part III provides a brief assessment of similar implications for low-income developing countries if the EU–India bilateral FTA deal is extended beyond goods to cover services trade.

Part IV deals with the remaining specific tasks, and consists of recommendations for policy measures for the low-income developing countries (such as ACP countries and South Asian countries) to mitigate any likely adverse consequences of an EU–India bilateral FTA, and measures that the multilateral system can undertake to help the poorest countries withstand the impact of the deterioration of their preferential margins in the EU market triggered by the EU–India FTA.

The team that produced this report, all based at the Centre for the Analysis of Regional Integration at Sussex, at the University of Sussex, UK, consisted of Michael Gasiorek, Javier López González, Peter Holmes, Maximiliano Méndez Parra, Jim Rollo, and Anirudh Shingal, with L Alan Winters as co-ordinator and corresponding author.

The views expressed are the authors' alone and do not necessarily reflect those of the University of Sussex, any other organisation with which the authors are associated or the Commonwealth Secretariat.

L Alan Winters,
University of Sussex, 16 September 2008.

Summary

This book deals with the consequences for excluded countries of a possible EU–India FTA. The FTA is in the early stages of negotiation, so it is impossible to know how it will eventually turn out, but we argue that this is precisely the right time to start to consider its implications, for it is not yet set in stone and excluded countries may be able to influence its form in ways that reduce the harm it does to them, without inconveniencing the two parties themselves. A consequence is, however, that we have to proceed by assumption. In the absence of information about the tariff reductions that will be agreed, we assume that all tariffs in goods markets between the two partners are abolished immediately. This means that our estimates provide upper bounds on the effects of the FTA. We also discuss the possibilities that the FTA will include services, and if so, the parameters of a services deal and the consequences for excluded countries.

All the analysis in this book uses detailed international trade data to identify patterns in international trade that are in theory and experience associated with positive or negative impacts from FTAs. Given the uncertainty about the shape of the FTA and the complexity of the forces in operation, we do not pretend to produce unambiguous statements of gains and losses. Rather we seek to identify which sectors and which types of countries may be most heavily impacted. As the title implies, we are mainly interested not in the EU and India but in all other countries – the excluded countries.

The EU–India FTA is part of the EU's 'Global Europe' initiative in which the EU has been seeking trade agreements with major global markets rather than just its previously closely associated states such as the African, Caribbean and Pacific states or its neighbourhood countries. 'Global Europe' carries a good deal of discussion about so-called deep integration – co-operating on regulations, standards, competition policy etc. – and liberalising trade in services. The interest in deep integration is plain in the rhetoric of policy makers on both sides of the EU–India FTA negotiation, but our estimate is that rather little will be achieved other than in certain service sectors. For goods markets, we expect a somewhat asymmetric FTA with India offering less and slower liberalisation than the EU, but to remove any arbitrariness from our results in this book we analyse the FTA as if all tariffs on goods trade between the two partners are removed immediately.

The usual approach to calibrating the effects of an FTA on excluded countries is to focus on '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 Indian preferences offered to the EU. This publication adds and quantifies two further concepts. First, with trade re-orientation, EU preferences again switch trade towards India (and vice versa), but this time there are no efficiency losses because the excluded country was initially supplying the EU not because of its efficiency but because it already had a preferential trade deal. The EU–India FTA 'undoes' that previous act of trade diversion and so saves the EU real

resources. From the point of view of the excluded country, however, the result is just the same as diversion – it loses sales – and so we have to consider the two together for the excluded countries' welfare. The second concept is that these trade impacts may affect the prices of excluded countries' exports. This may be more significant than a decline in exports per se because it implies earning less on every unit of exports, rather than just losing marginal units of exports, which may indeed cost very nearly as much to produce as they fetch on the market.

The detailed analyses of the markets for goods asks whether the excluded countries export similar goods to the EU as does India, and similar goods to India as does the EU. It then asks whether their exports are concentrated in commodities in which there will be large changes in EU tariffs on India or Indian tariffs on the EU and whether, within those markets, the two partners have good chances of increasing exports to each other and hence of displacing excluded countries' exports. Finally, it asks, within that last set of markets, whether the EU and India have large shares of each others' markets. If India provides a large share of EU imports of good X and the EU removes a large tariff on imports of X from India, we hypothesise that other (excluded) countries exporting X will feel a strong increase in competition, and hence will be more likely to reduce their prices in order partially to protect their market shares.

Briefly the conclusions are:

- The dissimilarity of composition of export structures between the partners' exports to each other and excluded countries' exports to them suggests that the scope for negative effects arising from the EU–India agreement is relatively limited.
- The SAARC[1] countries are by a long way the most vulnerable to negative impacts from the FTA. Their exports to the EU are more similar to India's and they are more dependent on the Indian market than are other countries. Among them, Bangladesh is the most exposed in the EU market (fully 58 per cent of its worldwide exports are exports to the EU of products for which India will receive preferential access), followed by Pakistan and Sri Lanka. However, the extent of the tariff differential in India's favour – i.e. the competitive edge that it gains from the FTA – averages only 3 to 4 per cent, so its effects will generally be limited.
- In the Indian market, the most exposed are India's two landlocked neighbours, Bhutan and Nepal, at least if their varieties of export products compete directly with the EU's falling in the same heading. Here, the EU receives a huge competitive advantage from the tariff differential within the FTA, of about 20 per cent, so the changes to trade patterns could be quite large.
- The BRICS (excluding India, of course) will generally experience trade diversion rather than trade re-orientation in the EU market, especially in manufacturing. Since the tariff preference for India is relatively small and the EU is not a predominant market for them, however, the effects will not be unmanageable. In the Indian market they suffer considerable competitive pressures from the improved access for the EU, but since they trade little with India, it is not of great significance in aggregate.

- ACP countries will mainly suffer from trade re-orientation as India receives preferences from the EU as deep as their own. They may also suffer from some form of trade diversion as a result of the EU getting enhanced access to India and possibly also in the EU market because of the extent that *de facto* they face GSP rather than Cotonou tariff rates because they cannot satisfy the rules of origin for the latter. Again, with the exception of the Eastern and Southern Africa region, the effects will be pretty small, because their trade is heavily concentrated in products for which India already receives zero tariffs in the EU (and so in which there is no change in Indian access from the FTA) and because their exports to each partner are relatively small.

- In both the EU and India the majority of the tariff lines that 'could' be affected by trade re-orientation or diversion are in the manufacturing sector, although in the EU the extent of diversion is likely to be larger in agriculture because protection is higher in this sector.

- In general, the trade impacts are sufficiently small that excluded countries are unlikely to suffer serious terms of trade declines. The most vulnerable in this regard are India's neighbours – Bhutan, Nepal and Sri Lanka – in the Indian market, and Pakistan in the EU market.

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, so we cannot replicate the sort of analysis that we undertake for goods. We do, however, identify a number of sectors where serious liberalisation in the EU and/or India might be feasible and note that if it occurs some excluded countries may lose market shares. Most poor countries, however, are not strong in the sectors concerned and so the effects here are fairly muted. We consider the possibility that the FTA may boost EU investment in India's services sectors at the expense of other possible poor recipients, but do not find major cause for concern here either. 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 book deals briefly with policy responses – by individual excluded countries and by the multilateral system. With so many uncertainties about the FTA, 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 should seek information from the partners on the progress of the negotiations and raise specific issues with the parties if the details (for example, with regard to particular sectors or industries) look particularly threatening. In doing so they could seek concessions to mitigate their difficulties by, for example, seeking lower tariffs for their exports in India and less binding rules of origin and help with meeting standards for exports to the EU. 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. If they conclude that this is the route to pursue, groupings such as the Commonwealth may become important focal points of their efforts.

It would be nice to conclude with a definitive recommendation on the question of the correct stance for small and poor countries on FTAs and the trading system. However, the evidence about the relative merits of these two approaches is complex and ambiguous, and both the policy communities and the economics profession are divided on them, so a thorough discussion must be postponed to another occasion.

Note

1 Country groups and other acronyms are defined in the List of abbreviations on pages xiii–xiv.

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List of abbreviations

ACP	African, Caribbean and Pacific
AD	Anti-dumping
ASEAN	Association of South-East Asian Nations
BIS	Bureau of Indian Standards
BRIC	Brazil Russia India China
CA	Central Africa[2]
CA	Conformity Assessment
CARICOM	Caribbean Community and Common Market[3]
CEEC	Central East European Countries
CGE	Computable General Equilibrium
CRS	Computer-related Services
CVD	Countervailing Duties
DFID	Department for International Development
DII	Deep Institutional Integration
DMI	Deep Market Integration
DOI	Deep Outcome Integration
EBA	Everything But Arms
EEA	European Economic Area
EEC	European Economic Community
EFTA	European Free Trade Association
EPA	Economic Partnership Agreements
ESA	East and Southern Africa[4]
EU	European Union
FDI	Foreign Direct Investment
FKI	Finger-Kreinin Index
FSP	Foreign Service Providers
FTA	Free Trade Agreement
FTAA	Free Trade Area of the Americas
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GLI	Grubel-Lloyd Index
GoI	Government of India
GP	Government Procurement
GPA	Agreement on Government Procurement
GSP	Generalized System of Preferences
GSTP	Global System of Trade Preferences
GTAP	Global Trade Analysis Project
HS	Harmonised System
IIT	Intra-industry Trade

IPR	Intellectual Property Rights
LDC	Least Developed Countries
MFN	Most Favoured Nation
MR	Mutual Recognition
NAFTA	North American Free Trade Agreement
NTB	Non-Tariff Barriers
OBS	Other Business Services
OCS	Other Commercial Services
OECD	Organization for Economic Cooperation and Development
PSU	Public Sector Undertaking
PTA	Preferential Trading Arrangement
RCA	Revealed Comparative Advantage
RIA	Regional Integration Agreements
ROW	Rest of the World
RTA	Regional Trade Agreement
SAARC	South Asian Association for Regional Cooperation
SACU	South African Customs Union
SADC	South African Development Community[5]
SAFTA	South Asian Free Trade Agreement
SITC	Standard International Trade Classification
SME	Small and Medium Enterprises
SPS	Sanitary and Phyto-sanitary Measures
TBT	Technical Barriers to Trade
TRAI	Telecom Regulatory Authority of India
TRAINS	Trade Analysis and Information System
TRIPs	Trade-related Intellectual Property Rights
USA	United States of America
USO	Universal Service Obligations
WA	West Africa[6]
WTO	World Trade Organization
ZAF	South Africa

Notes

2 CA: Cameroon, Central African Republic, Chad, Congo Rep. Dem., Congo Rep., Equatorial Guinea, Gabon, Sao Tome & Principe.

3 CARICOM: Antigua & Barbuda, Bahamas, Barbados, Belize, Dominica, Dominican Republic, Grenada, Guyana, Haiti, Jamaica, Montserrat, St Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Suriname, Trinidad & Tobago.

4 ESA: Burundi, Comoros, Djibouti, Eritrea, Ethiopia, Kenya, Malawi, Mauritius, Madagascar, Rwanda, Seychelles, Sudan, Uganda, Zambia, Zimbabwe.

5 SADC: Angola, Botswana, Lesotho, Mozambique, Namibia, Swaziland, Tanzania

6 WA: Benin, Burkina Faso, Cap Verde, Gambia, Ghana, Guinea, Guinea-Bissau, Ivory Coast, Liberia, Mali, Mauritania, Niger, Nigeria, Senegal, Sierra Leone, Togo

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.

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Part I

Background

Chapter 1

The effects of preferential trading arrangements (PTA) on excluded countries: Welfare not quantities

This chapter briefly introduces the conceptual framework we use for thinking about the effects of preferential trading arrangements (PTAs) on excluded countries. It is much more explicit than most treatments about what really determines economic welfare – prices, incomes and profits, rather than just economic activity (production and sales) *per se*[8]. It does not suggest the irrelevance of the traditional calculations of the effect of FTAs on excluded countries' welfare, but certainly advocates supplementing them.

The vast majority of the literature on PTAs emphasises the positive and negative effects emanating from 'trade creation' and 'trade diversion', respectively. In the event that the former outweighs the latter, the PTA is deemed to be beneficial. This is a far from perfect metric even for the partners, but its robust common sense and easy application have made it very popular and almost certainly not seriously misleading. But while it may be appropriate for countries inside the PTA, it is inappropriate for the countries that are excluded from it. For such countries trade creation is largely irrelevant, while trade diversion *may or may not* represent a loss.

The price effects of a PTA

The most common argument about the way in which a PTA hurts an excluded country is through trade diversion strictly curtailing its exports to the PTA relative to the position that would have been observed in the absence of the PTA. However, if the price of the lost exports equalled their marginal cost of production and sale (including normal profit) and the loss of exports is not very large, then, apart from costs of adjustment as resources move from one activity to another, the excluded country does not suffer any first-order welfare loss. The resources released are just as valuable as selling the export and buying an import instead. If, on the other hand, export prices exceed marginal costs, then for each unit of exports lost, real income falls by the difference between the value of exports in terms of imports bought and the value of the resources foregoing them they release into the domestic economy.

One way in which export prices may exceed marginal cost is if exporting generates super-normal profits because export markets are imperfectly competitive. Such profits are then lost on any trade that is diverted and cannot be replaced by alternative sales at the same price. Similar is the case with industries having economies of scale. If the creation of a

PTA causes industry in the rest of the world to lose scale economies, then the cost of all its output increases, imposing costs on its other customers and reducing its profit margins. Haaland and Norman (1992), for instance, predicted EFTA losses from the creation of the Single Market in the EU from exporting, but the evidence for these is generally rather weak despite the frequency with which they are referred to.

Another important source of difference between export values and marginal costs is export taxes. If a PTA cuts an excluded country's exports, the released resources cover the cost of production, but not the tax, and aggregate income falls. Related to this – and potentially more important practically – is the so-called Lerner symmetry theorem, which states that export taxes are equivalent to import taxes. This suggests that a country that taxes imports – has tariffs – can lose from its neighbours' PTAs. The story is as follows: tariffs reduce the level of imports below the optimal level and mean that a unit of imports is valued by consumers at more than it costs the *country as a whole.* Consumers value it at $(p + t)$ – the price plus the tariff – we know this because that is what they are willing to pay for it – but it costs the country only p, the tax just being recycled by government to consumers in their role as taxpayers. If for extraneous reasons, like a PTA, exports fall, imports must eventually follow. Since these imports are worth more than they cost, welfare is lost as they fall.

The second way in which a loss of exports can affect an excluded country is via the prices at which exporters can sell their products. This depends partly on the size of the PTA in question, or more specifically on the importance of the trade flow on which a preference is granted. While small PTAs will rarely matter as they generally will not affect the prices at which trade occurs, large agreements like the EU or the FTAA are large enough to affect world prices. Their behaviour has implications for everyone in the market – positive for buyers if prices fall and negative for sellers – whether or not they deal with the PTA itself. The significance of price changes is that they affect not just marginal trade, but the whole volume of existing trade.

If markets are segmented so that prices for identical goods vary between them, even small PTAs may affect the pricing behaviour of suppliers to the preferred market. When a member-country firm benefits from a preferential tariff concession it becomes more competitive in the PTA market, and excluded country firms may have to respond by reducing their prices in compensation. This is a simple terms of trade change for the exporter – it now gets less for every unit that it sells in that market – and we could measure the loss as x^*dp, where x is the volume of exports and dp the induced change in price. Exporters may be able to avoid some of the loss by redirecting exports to other markets or switching resources to producing other goods, but, unless these are easily achieved and generate the same revenue as the lost exports, there will be a loss. These effects are likely to be larger if markets are not only segmented, but goods are differentiated by place of production and/or place of sale so that each trade is strictly-speaking unique. If the trade flows affected by this are relatively large, the PTA could lead to appreciable loss of welfare for the excluded countries. For instance, Gupta and Schiff (1997) provided evidence of such 'large market' effects even for small countries in sales of live cattle in South America.

Looking at the large country case, Robert Mundell (1964) elucidated the terms of trade effects of a PTA in a three-country general-equilibrium model with goods being gross substitutes and price changes occurring to restore balance of payments equilibrium in response to an initial preferential tariff shock. He showed that for a single preferential tariff change by one member, the preferred exporting partner's terms of trade improved, while those of the excluded country deteriorated. Since a PTA amounts essentially to the two partners swapping such concessions, the excluded country potentially loses at every turn.

Despite the importance of price effects like this in the theoretical literature on trade policy, not much empirical work was done on the terms of trade effects of PTA until the last decade. Winters (1997b) could not locate a single empirical *ex-post* study of the price effects of a PTA. This stream of work started with Winters and Chang (2000), which examined the price effects of Spanish accession to the EC in 1986 on the exports of major excluded OECD countries. This work established beyond doubt that, as Spain offered preferential access to European Community suppliers, US pre-tariff export prices to Spain fell relative to those of the latter, but it recognised that it had not unambiguously proven that this reflected falling US prices rather than rising EC ones. For a variety of reasons, however, there seemed most likely to be at least an element of falling US prices, so the authors felt able to suggest that the PTA had had adverse effects on the excluded countries: 'reducing the pre-tariff price of US exports relative to that of member country exports by nearly half of any tariff differential'.

A more thorough exercise was conducted by Chang and Winters (2002), which examined the creation of MERCOSUR. They postulated that excluded countries' firms' export prices to Brazil would be influenced not only by the tariffs that they faced, but also by the tariffs that their rivals in member countries faced, via the effect of the latter on the rivals' prices. Thus, in the case of MERCOSUR, excluded countries suffered a decline in their terms of trade as they reduced prices in reaction to the improved market access that their preferred rival competitors received within the integrating market. In this study, Chang and Winters were able to look at US export prices to Brazil relative to US export prices to other markets, as well as relative to those of Argentinian exports to Brazil. The comparisons between different US export markets made it clear that US firms had discounted sales to Brazil, with an estimated loss of $600 million per annum in the terms of trade.

Romalis (2007) and Razzaque (2008) both investigate the terms of trade effects of NAFTA. Razzaque uses a similar approach to Chang and Winters' and finds similar results for Bangladesh/Mexico price differentials. Romalis uses quite a different method, and finds that although terms of trade effects are evident, they are smaller than Chang and Winters'. He speculates that this is because the USA was already a highly competitive market so that margins could not be squeezed much further. Romalis also finds plenty of cases where imports from excluded countries disappeared, arguably an extreme form of terms of trade effect.

One of the recurring arguments about the effects of PTAs on excluded countries concerns the so-called Kemp-Wan theorem – one of the most elegant pieces of economic theory

ever. Kemp and Wan (1976) showed in a mere three pages that a customs union (a PTA in which all tariffs between members are zero and all members charge the same tariff to excluded countries) could be designed to have no impact on excluded countries while still being welfare-improving for members! They showed that the customs union could set a common external tariff that would keep net imports of every good from the rest of the world unchanged, thus assuring that it had no impact at all on the welfare of the rest of the world. Panagariya and Krishna (2002) extended the Kemp-Wan theorem to free trade areas (FTAs) and noted that in this case, member-specific tariff vectors implied that the domestic-price vectors differed across member countries, which in turn, implied that in an FTA (as opposed to a CU) marginal rates of substitution generally failed to equalise across union members. However, they showed that if member countries within the FTA individually imported the same vector of quantities from the rest of the world in the post-FTA equilibrium as in the pre-FTA equilibrium, then the FTA could also be designed to be neutral for the rest of the world and welfare-improving for members. The important point about Kemp and Wan's insight were, first, that it did not define what would be good or bad for excluded countries, merely how to render them indifferent to a CU or FTA. Second, Kemp and Wan proved that one could conceive a PTA that did not affect excluded countries, not how to construct it.

Many markets

The discussion so far is based on partial equilibrium models which consider a single market in isolation, but of course PTAs typically concern a whole range of goods. The basic impacts by market are just as we have described them, but if a PTA has a significant effect on many markets it seems likely to affect the aggregate balances of the economy such as the demand for labour and capital and the need to keep the balance of trade at its initial level. Once these aggregate constraints are recognised – e.g. wages rise because the PTA creates excess demand for labour at the initial wage – there will be feedbacks onto each and every one of the individual commodities. These are generally not particularly large and so the partial equilibrium results will often be a quite sufficient basis for thinking about policy, but it is clearly useful to ask how the overall balance of the economy is affected. Moreover, by aggregating up and following the stimuli created by the PTA through all parts of the economy we are able to derive more convincing estimates of the overall welfare effects of the policy.

For these sorts of analyses the preferred tool for simulating the impact of PTA on included and excluded countries is Computable General Equilibrium (CGE) modelling. General equilibrium recognises that markets interact in complex ways such that everything depends on everything else. 'Demand for any one good depends on the prices of all other goods and on income. Income, in turn, depends on wages, profits, and rents, which depend on production, which depends on sales (this is, demand). Prices depend on wages and profits, and vice versa; supply and demand must be equal in all markets, including factor markets; and imports must be paid for by exports plus foreign borrowings.' (Schiff and Winters, 2003, p. 48). But of course nothing is free. The need to measure all these links makes CGE models less informative and detailed in other ways. Thus, for example,

the models are almost wholly based on *a priori* theorising about the economy and their results dependent on parameter values that have not been formally estimated. They are too complex ever to be thoroughly tested against actual evidence, and in fact any testing against actual outcomes is rare. A notable exception is Valenzuela et al., (2005). Conclusions drawn from CGE models on the effects of PTA are sensitive to the values chosen for tariff and NTB in the baseline scenario and simulation experiments. Moreover, because they model markets in a way that assumes that goods are differentiated by place of production, every good is unique and so tariff reductions tend to emphasise trade creation over diversion. (The simple substitution of one source for another is limited by the fact that every good is different, so that there is less scope for diversion from one source to another.) Given this, it is remarkable how often these models suggest that PTAs will be harmful to members. But having unique goods also ensures that tariff shocks will always affect prices to some extent, so these models also almost always suggest negative terms of trade shocks for excluded countries and thus predict losses for them.

Against this background, we now review some results from the CGE-based literature. Using a CGE model to calculate the effects of a Free Trade Agreement of the Americas, Brown, Kiyota, and Stern (2005) found that the elimination of tariffs on manufactures in the FTAA would lower welfare in all but two of the 16 non-participating countries and regions that were included in their model. They found the FTAA to be trade diverting for most of ROW, with a welfare reduction of $9.3 billion per year.

Francois, McQueen and Wignaraja (2005) conduct an analysis of the EU's PTAs with five of its trading partners (Chile, Mexico, South Africa, Egypt and MERCOSUR) and show that the benefits for the EU are estimated to be in the range of $9.1 billion annually (based on 1997 GDP). Most FTA partners (except Egypt) benefit from the direct effects of the agreement. However, most of the ROW loses, including countries such as Botswana, North Africa and the Middle East. The results for Botswana (with a loss of about $377 million annually) point to losses for Southern Africa in general[9]. Welfare losses for Botswana and Southern African from the EU-South Africa FTA are also confirmed by the GTAP study by McDonald and Walmsley (2003) who find that the losses in Botswana and the rest of SADC amount to $71.5 million and $14.2 million, respectively.

To summarise, assuming that the EU–India agreement actually achieves significant liberalisation between them, there is at least a strong probability that it will harm excluded countries. For several reasons, however, this harm may not be particularly large. In many cases excluded countries' trade completely different goods with the EU and India than those partners trade between themselves. In others, EU–Indian trade is sufficiently small that the impact of favouring it is likely to be small. In others, excluded countries have sufficient flexibility to use the resources released by trading less with the partners equally productively for other purposes, while in yet others they have sufficient other market opportunities to be able largely to ignore smallish shocks to EU or Indian markets. The remainder of this book is essentially devoted to testing and quantifying one part of these possibilities. It seeks to ask where trade overlaps and how important EU–Indian trade is. However, further study is needed to be able to say how easily excluded countries will be able to cope with, or accommodate, any negative shocks that emerge from that analysis.

Notes

8 Parts of this chapter draw on Chang and Winters (2002a) and its related literature.

9 'The BNLS (Botswana, Nambia, Lesotho and Swaziland) countries face, as a result of the combination of the customs union agreement with South Africa (SACU) and the EU-South Africa (RSA) free trade agreement, increased competition from the EU, both in their exports to, and in their imports from, South Africa and will incur a loss of tariff revenue (significant for Lesotho and Nambia) from the common revenue pool.' [All customs and excise duties collected by the five members of the SACU are pooled into a Common Revenue Pool and distributed to them according to a Revenue Sharing Formula. A significant component of the new formula is the customs component, consisting of all customs duties actually collected. According to the new formula, the sharing of the revenue from customs duties is to be determined on the basis of each country's percentage share of total intra-SACU imports, excluding re-exports, and not on the basis of SACU imports from the rest of the world.] 'South Africa is also a member of SADC and these southern African countries will face a loss of regional trade with South Africa as a result of the trade creation (*sic*) effects of the free trade agreements. In addition, unless South Africa offers the SADC countries preferences equivalent to those available to the EU there could also be significant trade diversion against SADC. These negative effects on regional trade are reinforced by the EU rules of origin which allow South Africa to cumulate origin with only one ACP (including SADC) country, while the producer in South Africa has to add 100 per cent to the value of imports of intermediate products from the regional partner in order to qualify for preferential entry into the EU market.' (Francois, McQueen and Wignaraja, 2005, p. 14)

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Chapter 2

EU Trade Agreements: What can we expect an EU–India Agreement to cover?

This chapter briefly sketches the history of EU thinking about trade agreements, showing that bilateral and regional arrangements have always had a major role. In the last decade we have seen the EU move outside its region and former colonies to focus on larger developing country and emerging markets. EU–India must be seen as part of this progression. In these agreements, and even more so in agreements with the ACP states, the EU has encouraged considerable asymmetry over the degree and timing of liberalisation. We expect to see this in goods markets with India but probably to a smaller extent than previously. EU rhetoric has also come to stress so-called deep integration – regulatory harmonisations and liberalisations and a focus on services. The latter are particularly significant for India. There are huge potential gains from deep integration for the partners to an agreement if it can be achieved, but the consequences for excluded countries are mixed: in some cases new discrimination could arise but in others excluded countries will benefit from the reforms induced by the bilateral agreement. Moreover, given the histories of the two partners, we do not actually expect a huge amount of deep integration.

A brief history

As a successful customs union the EEC, and now the EU (as we will refer to what has now become the European Union), has always been ambivalent about the benefits of a purely multilateral approach to trade policy. Especially in recent years the EU has seen the GATT/WTO as representing, in a limited way, an extension on to the global plane of its internal 'rules-based' regime and has pronounced itself committed to this system. But simultaneously, since the 1960s the EU has constructed a spider's web of bilateral and plurilateral trade agreements, mostly with developing countries, that means that it conducts trade with the vast majority of its partners on a preferential non-MFN basis. On the other hand, the small number of partners facing MFN tariffs, including the US, Canada, Australia and Japan, are large, and China receives only rather limited preferences, so that a high share of trade still goes through the non-preferential gateway.

Historically the main preferential agreements were with the African, Caribbean and Pacific (ACP) partner countries and the countries of the Mediterranean region. The 1963 Yaoundé convention which gave preferential market access principally for industrial goods to former French colonies was transformed in 1975 into a sequence of Lomé conventions which broadened preferential access to UK ex-colonies in Africa, but not Asia. Lomé also provided for some commodity price stabilisation. The Lomé system was

replaced in 2000 by the Cotonou convention. Several of the key characteristics of the Contonou regime and also the early Euro–Med agreements were, however, incompatible with the principles of the GATT and in the post 1994 era the WTO required that these rules be respected (Christopher Stevens and Jane Kennan, 2002).

In particular, the agreements were non reciprocal and incomplete. The EU opened its markets to ACP country goods but they did not have to liberalise their imports in the same way. This violated Article XXIV of the GATT. In the case of the early generation of Euromed agreements an attempt was made to square the circle by declaring that the agreements were full free trade areas but that the market opening by the southern partner was to be postponed more or less indefinitely.

In the case of the agreements with the Mediterranean partners, the EU began to address this problem head on in the 1990s and began to sign a series of agreements with Egypt, Morocco, Tunisia et al. which were indeed to be considered full free trade agreements, even though still slightly asymmetrical in timing and having less than full agricultural coverage. For the ACP partners the problems proved harder to deal with. The WTO membership agreed in 2000 to give the non-reciprocal Cotonou agreement a waiver until 2008 after which time the EU was expected to sign agreements that were fully in conformity with the WTO rules, or else to revert to non-discriminatory arrangements, although in this case 'non-discriminatory' means arrangements which do not discriminate between similarly placed developing countries; the deep and far-reaching 'Everything But Arms' (EBA) preferences are limited to least developed countries and hence discriminate in their favour relative to other agreements.

The EU eventually decided to propose ostensibly GATT-compliant Economic Partnership Agreements to the ACP partners. The problems with these do not need rehearsing here but it is worth noting that the current generation of agreements must also abide by the General Agreement on Trade in Services (GATS) Article V if they include any services elements. This provision is broadly similar, although more precisely worded, than the provision in the GATT Article XXIV that requires 'substantially all trade' to be covered.[10]

As well as the ACP and Mediterranean countries, the EU has also extended its neighbourhood policy further into Eastern Europe including countries such as Ukraine among its partners. These are essentially political agreements rather than primarily economic or mercantile ones. At the same time, however, the EU has concluded in the last 10 years a series of agreements that can hardly be described as 'regional' trade agreements, with partners such as Mexico, Chile and South Africa. In some cases these reflected political motives. Patrick Messerlin (2001) has observed that, lacking a fully-fledged foreign policy instrument, the EU is forced to offer trade cooperation as the only form of alliance available to non-members. There were economic motives behind the FTA between EU and Mexico in 1997 but there was also clearly the diplomatic desire for Mexico not to fall totally under US influence. The, as yet stalled, EU-Mercosur talks were probably inspired by similar motives. At the same time some countries such as Chile were driven by what Baldwin (1993) has called the domino effect to seek the same market access to the EU as the most favoured partners were getting (i.e. the same as those partners who received better treatment than the normal MFN tariff provided).

Many economists regret these moves as likely to cause direct economic distortions through trade diversion, and systemic damage to the multilateral system, if only by absorbing scarce negotiating capacity.

The lack of progress in the Doha Round at first prompted the EU to hold back on FTA negotiations. But since 2006 the EU has embarked on an ambitious project to launch FTA talks with trading partners to whom it thinks market access is important for the EU itself, and the EU–India project fits into this series, even though it is reported that the initiative came from New Delhi.

'Global Europe'

In 2006 Peter Mandelson launched the 'Global Europe' scheme. Underlying this was the notion that the EU should consider its own offensive interests more clearly, and strive to achieve bilaterally what it could not get at the WTO. The list includes two important elements: the choice of large growing markets as partners and going beyond tariffs reduction as the way to get market access.

The EU's current strategy in trade agreements places great emphasis on 'deep integration' in the sense that it recognises that 'shallow' integration in the form of the removal of trade barriers at borders such as tariffs and quantitative restrictions is inadequate. It sees such agreements as important for Europe's 'competitiveness' (and also probably for its market access and influence on the world trading system).

The 2006 background paper on 'Global Europe' – European Comission (2006) – made it clear that the EU would be seeking to complement the WTO with bilateral trade deals with major partners.

> '**The key economic criteria for new FTA partners should be market potential** (economic size and growth) **and the level of protection against EU export interests** (tariffs and non tariff barriers).'

The text insists that the new generation of FTAs must address services and regulatory issues.

> '**New competitiveness driven FTAs would need to be comprehensive and ambitious in coverage**, aiming at the highest possible degree of trade liberalisation including far-reaching liberalisation of trade in services covering all modes of supply.'

It sets ambitious targets for the new type of FTA:

> '**Future FTAs would also need new ways of addressing non tariff barriers**. The effectiveness of competitiveness-driven FTAs will depend in part on their capacity to tackle non tariff barriers. Our ability to tackle NTBs will differ depending on our trade partners. Regulatory convergence, for example, is more likely to be achieved with neighbourhood partners than others. But these issues must be on the agenda with all our prospective partners. Mutual recognition agreements should be concluded where necessary and useful.'

The last sentence shows a degree of optimism or hubris, even, since the EU has had great

difficulty realising such agreements with the USA, and mutual recognition has been the last element of the internal market to function.

This focus on non tariff measures is known as 'deep integration' and it is to this aspect of the EU's ambitions for its agreement with India that we now turn. As we note, 'deep integration' implies major internal regulatory reform and it has been suggested that this is an aim of the Indian side in approaching the EU. The EU paper claims:

> 'Our potential partners such as India, Korea and ASEAN seek a very high level of ambition as regards investment which goes well beyond the provisions of current EU FTAs.'

The term Deep Integration was first coined by Lawrence (1996). He used it to refer to a process of removing barriers to trade and investment that are *behind the border*, notably regulatory barriers or even mere differences that make it harder to do business across borders than within jurisdictions. The term deep integration should perhaps be subdivided to distinguish the policy dimension, which we refer to as Deep Institutional Integration (DII), from the autonomous market processes that the private sector initiates to make trading easier – Deep Market Integration (DMI). We can also distinguish 'Deep Outcome Integration' (DOI), referring to the intensity of trade, as a way to highlight the fact that the aim of market and private institutions is to actually affect trade flows.

DII refers to any element of an FTA that essentially addresses the barriers to trade caused by regulations that are discriminatory or even just different and hence create problems for traders. It covers a broad range of domestic policies including the following, all of which the EU has sought to include in trade agreements:

- Services regulation
- Investment rules
- Standards and technical barriers including SPS measures (and related regulations and procedure such as testing and certification)
- Competition policy (or its absence if that leads to private barriers to entry)
- In some cases, migration rules
- Intellectual property rules
- Subsidies
- Government procurement

Several fundamental arguments have been advanced for moving beyond shallow integration to DII:

1. When tariffs are low their removal has little effect, whereas if they are high there is a risk of trade diversion; removing regulatory barriers, on the other hand, is thought to be generally trade and welfare enhancing.
2. Where there are, despite the qualifications above, potential gains from Shallow Integration, these can only materialise if NTBs are also removed.

3 Experience of the European Internal Market programme and of the recent CEEC accessions suggests that the biggest effect of regulatory alignment does not so much lie in the improved market access as in the upgrading of standards (using this term loosely) across the whole domestic economy.

4 Evidence also suggests that the productivity enhancing effects of trade occur when fine degrees of specialisation occur, allowing firms to invest in learning by doing in particular product niches or steps in the value chain, and to take part in production systems that facilitate technology transfer. This places a premium on the emergence of private and public arrangements that can reduce transaction costs, enhance certainty and predictability of behaviour, and create markets that are contestable and free of adverse externalities.

The role of an FTA in promoting this deep integration is then to remove unnecessary regulatory obstacles to trade and to create a facilitating environment in which mutually advantageous private contracts and market-led institutional arrangements can flourish.

We have elsewhere tried to schematise the links between trade policy and new types of trade flows, such as the development of 'Smithian' specialisation in niche markets and production chains. We see Smithian specialisation as occurring when firms focus on a particular niche product (e.g. screws of a certain gauge) or one step in the chain of tasks going into a final product. This often involves separating service components from manufacturing. This 'unbundling' relies on markets that are credibly open and where quality can be assured without costly post-delivery inspection. These phenomena may show up in indicators of Intra Industry Trade in goods sectors, but trade in services is harder to measure.

We see a remarkable burgeoning of DMI and consequential trade patterns (DOI) in East Asia with only limited DII. Perhaps most remarkable is the intensity of trade links between China and Taiwan in the absence of any official diplomatic links at all or even regular direct flights![11] This leads to the possible conclusion that DII is unnecessary, although this is likely to depend on the individual circumstances and on the nature of the DMI taking place. Historically, however, a close relationship between DII, DMI and DOI has been observed, for example in the context of the EU.

EU–India FTA

The EU–India agreement has hardly finished its exploratory phase to date, with no concrete proposals having been made at all. Thus it is impossible to know what it might entail in the end. Some commentators have argued that there is thus little to discuss in a report of this kind. We would argue, however, that, on the contrary, the time to explore policy options is before they are set in stone so that the policy may be influenced. This book is part of this process. We naturally have to proceed by assumption and offer analysis conditional on those assumptions. Even if these assumptions turn out to be factually incorrect, we can still learn a great deal by considering their consequences[12]. Moreover, while a claim to be able to make precise predictions about the nature of a future EU–India FTA

would be fatuous, there are many indicators to guide our assumptions, some of which are public and some private to this research team which has devoted a good deal of time to discussing the possibilities with experts and officials.

General statements of intent are available from the Indian and EU sides in Government of India (2007) and European Commission (2007) and brief progress reports from the press in, for example, *The Hindu* 4 March 2008.
(http://www.bilaterals.org/article.php3?id_article=11377), and *Bridges* 5 March 2008 (http://ictsd.net/i/news/bridgesweekly/11087).

One major source is the discussions that took place in the preparation of a joint Sussex/CUTS report to the European Commission entitled 'Qualitative analysis of a potential Free Trade Agreement between the European Union and India' in 2007 – Gasiorek et al. (2007). The report is the major source of the assumptions and discussion of them that follows. Its preparation, however, entailed detailed talks with senior public and private figures on both sides of the FTA, and so, although we have made no direct use of the content of those talks in the current paper, we have supplemented the published analysis with the background it provided. The discussions gave several of us a strong feel for current thinking and, along with our consequent analysis, a good deal of insight into the economic pressures and interests shaping an FTA. Hence, while overall, we wish to make no claims about predicting the content of the EU–India FTA, we are confident that in this publication we are analysing an appropriate and relevant set of issues.

Based on its earlier FTAs, the EU is likely to offer pretty far-reaching liberalisation of access to its non-agricultural markets in terms of border measures, but may well – and possibly to the Indians' relief – not wish to pursue liberalisation in agriculture very far. The Indians on their side seem likely to resist much liberalisation even in industrial products and we can expect to see some asymmetry in terms of both timing and of eventual tariff cuts. Given the size and growth rate of the Indian economy, however, the EU may not accept as much asymmetry as it seems happy to offer the ACP countries. Hence, in what follows we assume a full border liberalisation in goods even though we realise that this is not ultimately likely to materialise. Thus, our estimates of the effects on excluded countries are likely to be exaggerated in this dimension.

Potentially much more significant than tariff cuts is deep integration, which, as we saw above, now figures prominently in the EU's rhetoric. Here we have even less idea what will materialise but it is worth trying to think through some of the incentives and objectives that the partners might bring to the table. We briefly consider five possible components of deep integration. Modalities for dealing with them are sketched in Table I.1 on p. 27.

Government procurement

The Indian system differs from the provisions of the WTO's plurilateral Agreement on Government Procurement (GPA) mainly with respect to national treatment, transparency, and challenge and review mechanisms. India's biggest problem with any government procurement agreement is with the 'national treatment' requirement. This results from national and state governments using public procurement to direct investment to preferred sectors. There are no price preferences in this procurement at the central government level, only purchase preferences accorded to both SMEs and public sector enterprises. However, price preferences exist for state-level procurement and for purchases made by Indian Railways. There are no provisions in India that require information on winning contracts to be made public nor that each public body, on request, provides information on the reasons for rejection and the characteristics and relative advantages of the successful bidder. India also does not have a formal bid challenge procedure as there is no independent adjudicating authority, and the concerned department generally deals with disputes itself.

Transparency in procurement with respect to tender documentation specifying criteria for awarding contract, disallowing negotiations with the lowest bidder, requiring debriefing of the unsuccessful bidder and the publication of contract awards are issues that could be negotiated in a potential EU–India RTA. Most importantly, clearly defined arbitration, formal appeal or bid challenge procedures are needed. The EU could also negotiate a centralised database with information on government contracts in India, both at the level of the central government and for state-level purchases.

Investment

The various issues in investment are foreign direct investment (FDI) caps (mostly in services), barriers to effective implementation including transparency and state-level differences and other horizontal regulatory issues affecting investment climate.

Provisions on investment in a possible agreement could provide for transparency and setting up a system of a single window information system for investors of both the economies. Certain problems cannot perhaps be dealt with in an FTA, e.g. issues related to the ownership of land and labour policy in India. Such issues are state subjects and politically controversial. However, issues such as reservation policies for the small scale sector and positive list for India can be dealt with in an investment chapter.

Trade facilitation

While trading conditions in India have improved, the key issues of concern in trade facilitation in India are transparency, different implementation/enforcement policies, complex procedures for calculating customs duties, delays in customs clearance and inter-state variations in internal transit procedures.

The ambit of trade facilitation is very broad and the facets that could become the subject of a possible RTA include improving port logistics, facilitating inter-state commerce, har-

monisation of standards, encouraging business mobility, setting up trade information and e-business facilities, and fostering administrative transparency and professionalism.

Standards

There are several sectoral issues in Sanitary and Phyto-Sanitary Measures (SPS) and Technical Barriers to Trade (TBT) related to India but there is a general perception by the EU that the Indian approach lacks transparency and that standards issues (especially SPS), become politicised and that decisions are not always taken on the basis of clear scientific evidence. Further, there have been allegations even from within India that the Indian government has been using standards as non-tariff barriers especially after the abolition of quantitative restrictions in 2001. There are also horizontal factors such as the bureaucracy, corruption and the slow process of decision-making that affect the standards regime in India. The Bureau of Indian Standards (BIS) often appears to be slow and bureaucratic. Some of the sector-specific problems are in autos, bottled/mineral water, primary products, import of plants and animal products, etc. There are problems related to mandatory certification and maximum retail pricing.

There will always be differences in ways of dealing with sectoral and horizontal issues. There should, however, be overall transparency in the process of standards setting, and the scientific basis therein. There should also be transparency/clarity over the existence of standards and the lack of, for example, a single enquiry point. Both sides have argued for forms of mutual recognition but see this differently. The EU finds mutual recognition of certain standards acceptable, but does not favour mutual recognition of conformity of assessment procedures. The Indian side, on the other hand, would like to have mutual recognition of standards and technical regulations coupled with an agreement with regard to conformity assessment. There are at least two ways to conformity assessment. First, two economies could make use of existing labs, certification and inspection bodies in each others' countries. Reportedly, such a process has already been initiated by the EC in India. Second, there could be accreditation of relevant bodies – a more cost effective procedure.

Services

The services sector is extremely important for the two trading partners and from the perspective of a potential RTA, a substantial coverage of services as in GATS Article V could help deliver improved access to mutual markets and more rapid liberalisation of India's services than can be accomplished unilaterally. The challenge for the RTA is not only to accelerate liberalisation in India's services sectors (which is continuing albeit slowly at times and at a varied pace across sub-sectors), but also to facilitate the implementation of a range of complementary reforms designed to improve the quality of regulation[13].

We explore the possible effects of the EU–India FTA on services in more detail in Part III .

The prospects for agreements on elements of deep integration

The potential agenda on deep integration is huge and important. If we are realistic about

the EU's and India's track records in pursuing deep integration we have to admit that the prospects of far-reaching reform are quite small. Prior to the current administration, the Indians have tended to be very cautious about regulatory reform and conditions for it to occur are certainly not improving. On the EU side, despite all the talk, very little progress has actually been made towards deep FTAs so far. The EU has surveyed the deep provisions in its own FTAs and found them wanting (Bourgeois, J., Dawar, K. and Evenett, S., 2007). Strong agreements have been signed with the EU's neighbours and with accession candidates but with hardly any other partner.

> 'The current geography of EU FTAs mainly covers our neighbourhood and development objectives well, but our main trade interests less well. The content of these agreements also remains limited: they may deliver on market access commitments but even an advanced agreement like the EU–Chile FTA does not present major progress in areas such as IPR, subsidies, SPS or TBT.'[14]

How does deep integration affect excluded countries, especially in the present context, poorer ones such as the ACP States? If other countries continue to face regulatory barriers which have been selectively removed by the EU for India, trade diversion can occur. A paper by Chen and Mattoo[15] has argued that regional standards harmonisation can harm excluded countries' export prospects in this way. However, there is also a good chance that much deep integration will have fewer adverse effects on excluded countries than tariff reduction.

Often it is possible to make concessions only through reforms that affect all parties on an *erga omnes* basis. Indeed, some forms of market opening of this kind have to be MFN, so a deep FTA between the EU and India will have to open the Indian market to excluded countries. At one extreme, if India agreed to enforce competition policy against barriers to entry for imported products, it could not discriminate in favour of the EU. Moreover, since there has been so little movement in this direction in the past, a deep EU–India FTA could set positive precedents for future Indian liberalisations. In other cases, discrimination is possible, as, for example, if licences to establish or bring in key personnel are granted more liberally to partners than to non-partners. And given the importance of first-mover advantages in many service sectors, an agreement of this kind could significantly favour EU over other suppliers. However, these sectors are not of particular interest to poorer countries and the EU–India agreement seems unlikely to go in for too much explicit hard discrimination against others.

Bearing all this in mind in thinking about the *actual* impact on excluded countries of the prospective EU–India FTA, our tentative hypothesis is that it would be rare that other partners would lose significant market access through leapfrogging by the EU. However, especially among the set of countries which has been led to depend very heavily on the EU – e.g. the ACP states – excluded countries clearly need to be vigilant and might reasonably expect the EU to keep them informed and to offer them advances similar to those offered to India.

Table I.1. Ways in which Regulatory Barriers could be dealt with in an RTA[16]

	Preferential	MFN	National Treatment	Mutual Recognition	Harmonisation
Standards: (SPS, TBT)	MR with some partners.	Agreement that both parties will adopt ISO etc. norms.	Generally required by GATT Art III anyway.	For conformity assessment likely to be preferential.	EU presses for this, but limited value without CA MR.
Investment	Discrimination possible in industry so long as trade not affected. But de facto hard to apply if third country can buy into the industry.	GATS requirement unless Art V satisfied.	Agree to apply same rules to foreign firms as home.	Most likely to apply for services.	
IPR		Must be MFN under TRIPS. Rare case where you have to extend.	Generally required under TRIPS.	Unlikely.	EU & US call for this in some areas.
Trade defence	EEA removes AD.	Unusual.	n/a		
Services	Must satisfy GATS V. Preferences hard to apply if third country can buy into firms.	Quite likely; GATS obliges MFN for all sectors even if not scheduled unless exemption taken out in 1994.	Unlike goods only required for scheduled sectors; Preferences possible, but subject to Art V.	Home country regulation. Possible, but GATS has rules.	Possible.
Government procurement	Can be done.	GP not covered by GATT, only GPA.	Possible.	Would apply to approved lists.	
Competition Policy	Unlikely but could apply to takeover rules.	Most likely – would affect all partners.	Possible to apply to some or all.	Would imply MR of decisions.	Possible.
State aids rules	Hard to do except for CVDs.	State aid controls would affect all partners.			EU seeks to secure: bonus – removal of CVD rules.

Notes

10 The EU argues that PTAs which cover 90 per cent of mutual trade are compliant with the GATT Article XXIV requirement that they cover 'substantially all trade', and moreover that this can be translated into 100 per cent coverage in one direction and 80 per cent in the other. None of this has ever been tested via a dispute settlement or ruled upon by the General Council or Committee on Regional Trading Arrangements.

11 X.Li (2008) suggests that RTAs may have played a larger role in promoting East Asian trade (DOI) than is usually supposed.

12 The fact that you do not know exactly what the opposition will do in a football match does not invalidate the process of exploring their and your strengths and weaknesses, developing a strategy and making conditional plans.

13 See World Bank (2004) for more on this.

14 European Commission, (2006).

15 Chen, Maggie Xiaoyang, and Mattoo, Aaditya 2004, 'Regionalism in Standards: Good or Bad for Trade?' Policy Research Working Paper No. 345.

16 See also Hoekman, B. and Winters, L. Alan. (2007)

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Chapter 3

The effects of a potential EU–India FTA on the EU and India[17]

Introduction

As is well known, the potential net benefits from the process of preferential liberalisation are inherently ambiguous even for the partners undertaking the integration. This arises because PTAs typically involve both trade creation[18] (which is welfare increasing) and trade diversion[19] (which is welfare reducing). In addition, there may be further welfare gains arising from the induced growth effects stimulated by, for example, productivity growth, increased specialisation, and/or positive externalities between firms, sectors or across sectors (e.g. between manufacturing and services) which are typically more likely to arise in the presence of deeper integration. This chapter will briefly look at these in the context of a potential EU–India FTA, first in terms of partial equilibrium analysis of shallow integration, then in terms of qualitative analysis of deep integration and finally, by looking at some quantitative results from general equilibrium modelling.

Shallow integration

In assessing the likely shallow integration impact of an EU–India FTA on the two partners, we focus on a series of diagnostic indicators from which one can draw analytical conclusions well-grounded in economic theory. The aim of this analysis is to identify: (i) the potential welfare effects by assessing the scope for trade creation and trade diversion; (ii) whether there are any particular sectoral issues which arise from the preferential trade liberalisation between the EU–India. The analysis is based on a number of important rules of thumb, as identified in the Sussex Framework – see Evans et al. (2006).

The Sussex Framework uses simple models of the trade effects of preferential trade to derive indicators of the likely welfare effects of a particular agreement in terms of *observable data*. Thus, whereas the alternative approach to assessing regional integration schemes – computable general equilibrium modelling, which we turn to later in this chapter – uses a lot of theory but relatively little data to produce precise estimates of the effects of a trade agreement, the Sussex Framework uses the simple theory of trade creation and trade diversion and a lot of data to make broad and plausible, but, inevitably, not precise, predictions of its likely effects. The analytical thinking behind the Framework is discussed briefly as we introduce the various results below. It is also discussed in Part II, as well as in Evans et al. (2006).

***The higher are the initial tariffs/barriers**, the greater the likely levels of both trade creation and trade diversion.* While Indian tariffs have declined considerably, the average manufac-

turing tariff is still quite high at around 12 per cent. Certain sectors are still considerably more protected (food, beverages and tobacco, and animal and vegetable oils) and several others exhibit significant tariff peaks[20]. These tariff peaks are important as they not only indicate the potential for trade diversion (and even trade creation if no trade is taking place) but they also indicate which products are sensitive (and which would therefore most likely not be liberalised in a trade agreement). Of the 4,119 goods that India imported in 2005, tariff peaks existed on only 38 tariff lines, which represented approximately 1 per cent of the tariff lines. However, the tariff peaks themselves were quite high ranging from 15 per cent for HS47 to 160 per cent for HS21.

All this suggests that the existing levels of distortion are quite high, and that therefore, in liberalising its tariffs on EU exports, there is considerable likelihood of there being both trade creation and trade diversion into the Indian economy.

Table I.2. Tariff peaks on Indian imports from the EU in 2004

Cat. (HS2)	Description	No. prod. cat.	Av. tariff in cat.	Peaks	Av. tariff in peaks
87	Vehicles o/t railw/tramw roll-stock, pts & acc	58	34.05	13	100
47	Pulp of wood/of other fibrous cellulosic mat;	17	7.35	5	15
55	Man-made staple fibres.	82	17.20	3	75
26	Ores, slag and ash.	15	6.33	3	15
17	Sugars and sugar confectionery.	14	46.07	2	100
16	Prep of meat, fish or crustaceans, molluscs et	12	41.67	2	100
39	Plastics and articles thereof.	124	15.00	1	70
52	Cotton.	82	14.94	1	30
38	Miscellaneous chemical products.	62	16.90	1	50
33	Essential oils & resinoids; perf, cosmetic	35	23.43	1	100
41	Raw hides and skins (other than furskins)	34	11.47	1	30
8	Edible fruit and nuts; peel of citrus fruit	19	31.05	1	100
7	Edible vegetables and certain roots and tubers	18	35.00	1	100
21	Miscellaneous edible preparations.	14	39.29	1	160
6	Live tree & other plant; bulb, root; cut flowers	6	21.67	1	60
10	Cereals	1	0.00	1	30
Total		593		38	

Source: Gasiorek et al. (2007)

In comparison, the tariffs faced by Indian exports to the European Union are lower but there are far more tariffs peaks. Fifty-nine out of the 100 2-digit sections of the HS have tariff peaks, with a total of 371 tariff peaks. This corresponds to 10 per cent of the EU's import tariff lines. However, those peaks are quite different from the Indian ones, the average tariff in the peak is much lower, and ranges from 0.21 per cent for HS27 to 52.4 per cent for HS24.

Table I.3. Tariff peaks on Indian exports to the EU in 2004

Cat. (HS2)	Description	No. prod. cat.	Av. tariff in cat.	Peaks	Av. tariff in peaks
24	Tobacco & manuf. tobacco substitutes	8	21.61	1	52.40
4	Dairy, eggs, honey, & ed. products	7	4.25	1	17.30
3	Fish & crustaceans	37	6.69	2	14.23
19	Preps. of cereals, flour, starch or milk	14	2.35	1	14.10
7	Edible vegetables	36	5.73	1	14.02
21	Misc. edible preparations	12	5.74	1	12.80
8	Ed. fruits & nuts, peel of citrus/melons	26	3.51	6	10.22
6	Live trees & other plants	10	3.55	1	8.25
53	Veg. textile fibres nesoai, yarns & woven etc.	24	2.41	5	7.34
87	Vehicles o/t railw/tramw roll-stock	55	2.33	14	7.19
…		…	…	…	…
27	Mineral fuels, oils, waxes & bituminous sub	13	0.02	1	0.21
Total		2767		371	

Source: Gasiorek et al. (2007)

Since EU tariffs are already typically low, there would appear to be less scope for significant trade creation and trade diversion in the EU. This would, however, also depend on the underlying elasticities of supply and substitution between suppliers, and also on the extent to which small tariffs can have a big impact on differences in competitiveness across countries and on the tariff peaks.

The greater the number of FTA partners*, the more likely it is that there will be trade creation as opposed to trade diversion.* Looking at the number of countries involved in the FTA, from the perspective of the EU there is clearly only one partner country – India. In contrast, India would be signing an agreement, which involves 27 countries even if they have a single trade policy. The more countries which are included in the FTA, the greater is the likelihood of including more efficient suppliers. This in turn reduces the probability of trade diversion, and simultaneously increases the likelihood of trade creation.

The more similar is the product mix *in the economies concerned and the higher the elasticities of supply, the greater would be the possibility of trade creation.* The degree of similarity

between two countries is measured by the Finger-Kreinin index[21] (with regard to trade flows)[22]. Comparing EU and Indian exports to the world as proxies for production structures, the FK index is relatively low at 0.24, which suggests that, in terms of the export structure, the EU and India are fairly dissimilar[23]. This would, therefore, appear to suggest that on the production side there is not much evidence of scope for trade creation.

Wide differences in comparative advantage *between partner countries are likely to lead to a welfare improving FTA.* It is thus also important to consider the relative competitiveness of producers across the countries in the FTA, which is done through indices of revealed comparative advantage[24].

However, the preceding needs to be counterbalanced by the possibility of trade diversion. Despite being the single biggest supplier to India the EU still accounts for only 25 per cent of Indian imports, so the majority of India's imports are still sourced from outside the EU. This suggests that there is also considerable scope for trade diversion. Clearly it is unrealistic to suppose that the EU is competing here with all the other country suppliers. It is only in a subset of products where the EU has a comparative advantage, but across a range of other products and suppliers (e.g. oil) there will be little trade diversion. Nevertheless, the US already supplies more than 6 per cent of India's imports, and many other OECD countries and increasingly China are likely to be competing with EU producers. The degree of similarity across India's imports from the EU with India's imports from the rest of the world through the FK index is above 0.42. This suggest that there is a reasonably large amount of overlap – at a very disaggregated level – between what India imports from the EU and what it imports from the rest of the world. This again would appear to suggest scope for trade diversion.

There is another interesting feature of EU–India trade which re-inforces our conclusions with regard to trade diversion. This concerns the decline in the EU share of India's imports from 32 per cent in 2000 to 25 per cent in 2004. This suggests that under an MFN regime India's pattern of imports was shifting away from the EU towards other countries. To the extent that the signing of an FTA decelerates or reverses this trend in any commodity, one might presume that it is trade diverting.

To begin with, we focus on a comparison of the RCAs for the top fifteen exporting sectors for each country. Although focusing only on a small number of sectors, it appears that there is little similarity in patterns of comparative advantage between the EU and India, if one calculates a correlation coefficient between the EU and India RCAs across all sectors the result is –0.18. From this, one can conclude that the pattern of underlying comparative advantage differs considerably between the EU and India. If there were overlap in their production bundles, this would appear to suggest that there is some scope for trade creation on the production side. However, as discussed above, there does not appear too much overlap in this regard.

The overall conclusion from this discussion, therefore, is that with regard to the possible changes in Indian imports from the EU arising from a future FTA, there are clearly some possibilities for trade creation but that there is also considerable scope for trade diversion and the net welfare effect for India is therefore clearly ambiguous. To the extent that such

trade diversion occurs, from the EU's perspective, this implies an increase in demand for EU goods arising from the expansion of the EU's exports to India. As discussed earlier, whether this entails a net positive welfare effect for the EU will depend on whether the expanding sectors are being matched by contracting sectors elsewhere, or whether the expansion is using previously unemployed resources. Of course there is gain for the sectors which experience a trade-diverting increase in demand.

Deep integration

As we noted above, deep integration refers to a process of removing barriers to trade and investment that are *behind the border*, notably regulatory barriers or even mere differences that make it harder to do business across borders than within jurisdictions. The range of possible gains associated with deeper integration include: technology transfer and diffusion both through trade and FDI; pro-competitive gains from increasing import competition in an environment of imperfect competition, which may also allow greater exploitation of economies of scale in production; the increased geographical dispersion of production through trade that supports (i) exploitation of different factor proportions for different parts of the production process (Ricardian efficiency gains) and/or (ii) local economies of scale through finer specialisation and division of labour in production ('Smithian' efficiency gains); externalities arising from institutional changes that lead to a wide increases in productivity.

A key indicator of existing deep integration is the degree to which intra-industry trade (IIT) is taking place. Equally, the rate of growth of IIT might be thought of as an indicator of the potential for further deep integration. Broadly IIT takes three forms. Firstly, it is the exchange of similar goods (the same trade heading) of broadly similar qualities and prices; secondly, it is the exchange of similar goods of different qualities and prices; thirdly, it is the exchange of different goods at different prices within a trade classification that represents a vertically integrated supply chain (parts for finished or part finished goods). Each of these represent ways in which economic integration can encourage the niche specialisation that can generate the productivity gains that represent the main advantages of deep integration and can compensate for any losses to trade diversion from shallow integration.

Analysis suggests that intra-industry trade between India and the world started a good way behind that of China and Brazil in 1992 but had caught up and, indeed, may have overtaken both of them by 2004. All three, however, lag well behind the US. The low level of EU–India Grubel-Lloyd Index[25] (GLI) confirms the story of little direct overlap between Indian and EU trade patterns and competiveness. On one hand, this reinforces the inference that tariff cutting in an EU–India FTA could induce trade diversion losses for India given its high tariffs. On the other, it also underlines the potential for increased IIT, especially if TBT and SPS barriers were reduced as part of the FTA.

On the question of horizontal versus vertical integration, it is noticeable that, the EU apart, vertical differentiation greatly exceeds horizontal. This is not surprising in the case of India, China and Brazil since they are likely to export, say, low quality apparel and

import high quality, or to be part of globally or regionally integrated supply chains. It is, equally, not surprising that the EU is the exception where horizontal differentiation exceeds vertical, because it represents the most integrated market of national economies at broadly similar level of development in the world where the cross-hauling of differentiated, but similar, goods of equivalent qualities is likely. It is also worth noting that the share of horizontally differentiated trade grew faster than vertical in India between 1992 and 2004 perhaps representing improved quality of Indian goods.

EU trade with India is predominantly vertically differentiated, and, while the share of horizontally differentiated trade has grown faster, it is still at a very low level. Once more this suggests that there is potential for preferential liberalisation towards the EU to generate productivity-increasing specialisation particularly on vertically differentiated trade.

It is important to note that the domestic impact of deep integration is complex: there will be losers as well as winners. We might distinguish:

- Firms that are currently exporting who will have an improved home business environment;
- Firms able to enter export markets;
- Consumers who like products made to international (or FTA partner) standards;
- Home firms who cannot meet higher standards and go out of business;
- Consumers who do not want to pay for the international (or FTA partner) standards;
- And in the context of the present study – excluded country firms.

An obvious issue arises in the case of pressures to liberalise Indian retailing. It seems likely that opening to foreign competition will increase efficiency, but not only will many small shopkeepers suffer, so too will those consumers who will then be unable to access new retail outlets so easily[26].

General equilibrium modelling results

In addition to results from partial equilibrium and qualitative analysis above, results from a CGE study done by the Carnegie Endowment[27] simulating the effects of an EU–India FTA suggest that Indian exports would increase by $3.5 billion (5.5 per cent), with the largest increases seen in exports of apparel and textiles, which would increase by $1.9 billion, followed by increases in the category 'other manufacturing', notably leather and footwear (an increase of $520 million), chemicals ($220 million), and services ($230 million). India's imports would increase by $2.6 billion (3.4 per cent), concentrated overwhelmingly in manufactured goods, particularly capital goods ($2.1 billion), followed by smaller increases in imports of minerals and metals ($420 million) and chemicals ($360 million). India's imports of vehicles would increase by $120 million, while its exports of vehicles would increase by $60 million. Because the overall increase in imports would be less than the increase in exports, India's existing bilateral trade deficit with the EU would narrow. The criterion for economic policy is welfare, and in this dimension, India would

experience a very small loss (–$250 million): while exporting more, India would consume slightly less domestically, at least in the short run.

The impact of the trade agreement on India varies depending on the sector that is liberalised. The country would see little overall change as a result of agricultural liberalisation. Although agricultural production is a very important part of the Indian economy, trade in agricultural goods constitutes only a small portion of India's total trade. Its agricultural exports to the EU amount to 6.9 per cent of exports to the bloc, whereas imports of agricultural goods make up only 0.5 per cent of Indian imports from the EU. The liberalisation of agricultural trade with the EU would reduce India's overall domestic production very slightly (by $50 million), as increased imports of $70 million outstrip a $20 million increase in exports, and domestic consumption in India is largely unchanged. Liberalisation of trade in processed food has a slightly larger and more positive impact on India, with domestic production increasing by $200 million. As with agricultural liberalisation, imports increase more than exports ($120 million and $70 million, respectively) as a result of the liberalisation of trade in processed food; household consumption in India increases by $150 million. The impact on India of manufacturing liberalisation, by contrast, is larger and more varied. Bilateral elimination of tariffs on manufactures has a relatively large negative impact on Indian households, whose consumption declines by $1.5 billion (–0.5 per cent) despite a modest positive impact from EU liberalisation. Government tariff revenue also declines slightly. Investment increases by $1.1 billion (1 per cent). These results are dominated in each case by India's own manufacturing liberalisation measures, including the loss of tariff revenue that must be offset by increases in other taxes.

In contrast to the mixed results for India, the European Union would benefit unambiguously from the agreement, although to a very modest extent. Exports would increase by $1.3 billion, a gain of 0.05 per cent of total EU exports. A gain of $1.6 billion in exports of machinery, electronic equipment, and other durable manufactures would be offset by moderate losses in exports of textiles, apparel, and services. Imports would increase by $3.2 billion (0.12 per cent), with the largest increases in apparel and textiles ($750 million), chemicals ($230 million), minerals and metal ($250 million), vehicles ($190 million), other manufacturing ($710 million), and services ($510 million). The EU's existing bilateral trade surplus with India would decrease.

The impact on the EU of the bilateral liberalisation of agricultural goods and processed foods and of the EU's own liberalisation of manufactures trade is extremely small. The EU gains arise almost entirely from India's opening of its market for manufactured goods to its exports. The EU gains $2.4 billion in total consumption as a result of India's liberalisation of manufactured goods, offset by a slight loss of $220 million from the EU's own manufacturing liberalisation.

In another CGE study[28] on a potential EU–India FTA, two scenarios have been simulated. While these are identical with regard to protection in goods (95 per cent of tariffs are removed on both sides), the difference lies in the treatment of services. In the first scenario, protection in services is cut by 10 per cent, while in the second scenario a 25 per

cent cut is considered. In both scenarios, the tariff dismantling begins in 2007 and is fully implemented in 2013, with a shorter transition period for the EU. The impact of trade liberalisation on foreign direct investment is taken into account in the simulations. Given that the Carnegie Study does not involve services, we look at the simulation results for services from the CEPII-CIREM Report.

EU exports to India increase in all services sectors and in both scenarios. Overall, they increase by 5 per cent and 16 per cent in scenarios 1 and 2, respectively (+ US$0.5 bn and + US$1.6 bn, resp.). Yet, because India still represents a small market, bilateral trade flow increases do not translate for the EU into major positive impact at the level of its domestic economy. It is also worth noticing that services liberalisation is not sufficient to counteract the appreciation of the EU real exchange rate caused by goods liberalisation, so that total exports outside the EU decreases, except in the Business services sector.

India increases its export of services in all sectors, in both scenarios. This emanates from the overall gain in competitiveness of the Indian economy due to a depreciation of the real exchange rate. Overall, total Indian exports of services increase by US$0.6 bn in scenario 1 and US$1.2 bn in scenario 2 (+ 3.3 per cent and + 6.5 per cent respectively). The highest export increases are found in Trade and Business services (+ $201 mn and + $291 mn in scenario 1, + $434 mn and + $570 mn in scenario 2) but significant increases are also expected in transport, communication, other services, finance and insurance, with an increase between 1 per cent and 4 per cent of Indian exports in each of these sectors.

The conclusions for welfare are actually similar to those of the Carnegie study: the EU appears to be a small gainer in both scenarios, whereas India records small gains in one scenario and losses in the other. Some commentators have argued that anything that increases exports – as most EU trade agreements appear to do – must be a 'good thing'. We also agree that increases in trade in a relatively undistorted environment are likely to be beneficial, but preferential trade agreements not only take place in a distorted context, but generally increase the degree of distortion, so the conclusion that they are *prima facie* welfare enhancing is quite unwarranted. Rather one needs to examine each agreement specifically and add into the calculation the possibility that each increases the incentives for the next. When we look at arrangements between the EU and relatively low income developing countries (with what are admittedly rather weak tools), the general conclusion is that they reduce welfare. And if they do indeed then foster further moves towards regionalism, we may have cause to worry. We return to this issue briefly in Part IV.

Conclusion

To summarise, the outcome of a possible EU–India agreement would depend on the coverage of sectors and on the extent to which the agreement can look at the harmonisation of issues of deep integration. Both partial and general equilibrium analysis point to ambiguous benefits for India and at best, modest benefits for the EU, from a potential agreement especially if services are not covered. Thus, a potential agreement would have to go beyond the traditional tariff cuts of shallow integration to beyond-the-border issues of deep integration for it to have realistic positive implications for the two trading partners.

Notes

17 This chapter draws heavily on CEPII-CIREM (2007), Gasiorek et al. (2007) and Polaski et al. (2008).

18 There are two possible sources of trade creation. First, this can arise when more efficiently produced imported goods replace less efficient domestically produced goods. Thus, on the production side, trade is 'created' and this yields welfare gains. Second, even assuming no changes in domestic production a reduction in tariffs, leading to a reduction in prices increases demand for imported goods. This too leads to welfare gains as consumers have access to cheaper goods than previously. Here trade is 'created' on the consumption side.

19 Trade diversion occurs when the source of imports switches away from non-FTA partner suppliers to the new FTA partner.

20 These refer to tariff impositions on specific commodities which are three times higher than the average for the entire sector. There is no universal definition of peaks, but the factor of three has fairly widespread use – e.g. Deardorff (2006).

21 The F-K index of import similarity between country m and n can be defined, in general, as $FK_{mn} = \sum_i \min(\delta_{im}, \delta_{in})$. Where δ_{im} and δ_{in} are the share of imports from country m in product i and the share of imports from country n in product i, respectively. This index was computed at the 6-digit level of disaggregation. The FK index is equal to one when the structure of trade (defined by the share of each sector in total trade) across the two countries being compared is identical and is equal to zero when the structure of trade is completely different.

22 Ideally, one would like to be able to compute the index on patterns of production. However, data are simply not available at an appropriate level of disaggregation. Following common practice, therefore, the index is computed on the basis of trade flows, and one uses trade flow similarity as an imperfect proxy for production structure similarity.

23 For comparison, the FK index for EU and US exports is equal to 0.6.

24 An RCA is a way of measuring the competitiveness of a given country in each good compared to another country. It measures a country's exports of a commodity relative to its total exports and then compares this to the comparator countries' exports of a commodity relative to its total exports. A comparative advantage is 'revealed', if RCA > 1. If RCA is less then unity, the country is said to have comparative disadvantage in that commodity. The formula for RCA = $(X_{ij}/X_{it})/(X_{nj}/X_{nt})$ where X_{ij} represents exports of commodity j by country i; t represents all commodities and n all countries.

25 The GLI measures the overlap between the industrial structure of imports and exports (here measured at HS4) between any pair of trading partners. The higher the index, the greater the intra-industry trade overlap with an index of 1 representing total overlap. For an industry i with exports X_i and imports M_i the index is:
GLI $= [\{(X_i + M_i) - |X_i - M_i|\}*100]/(X_i + M_i)$.

26 Though with retail outlets mushrooming in every nook and cranny of the country, this may become less of a concern.

27 Polaski et al. (2008). This study covers just goods trade liberalisation.

28 CEPII-CIREM (2007), which covers both goods and services trade liberalisation, but no other aspects of deep integration.

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Part II

Excluded countries and the markets for goods

A trade agreement between the EU and India is likely to have trade creating, trade diverting, and trade re-orientating effects with attendant implications for excluded countries. This part of the report focuses on the possible scope for the negative effects on excluded countries arising from the EU–India agreement. In so doing we identify sensitive product lines and the countries that are most likely to be affected by the preferences granted by the EU to India and by India to the EU (bearing in mind existing preferential arrangements).

The analysis is based on diagnostic statistical indicators and rules of thumb as developed by the Sussex Framework (Evans et al., 2006). Trade diversion and trade re-orientation are more likely to occur when tariff differentials between partner and non-partner countries are high, and the composition of imports from preferential partners is similar to that of non-preferential partners. Using these simple rules of thumb across the spectrum of trade between the EU and other partners we approximate the possible degree of trade diversion and trade re-orientation by origin. The aim is to identify *who* might suffer negative impacts from the EU–India Agreement and to approximate the magnitude of these effects.

This part is composed of four separate chapters. The first analyses the degree of similarity of excluded country exports to partner exports to a given market. This gives us an indication of the similarity of exporting structures across excluded countries which allows us to conjecture about the possible magnitude of trade diversion or trade re-orientation that can result from the EU–India agreement. The second chapter looks at tariffs (at 8 or 10 digit level depending on data availability) faced by excluded countries in the target markets and investigates how EU–India preferences might affect excluded country exports. Here we differentiate across four possible scenarios; (i) no change in preferences, (ii) trade diversion effects, (iii) trade re-orientation effects, and (iv) combined trade diversion and trade re-orientation effects. Chapter 3 provides a more sectoral analysis of the likely impact of trade diversion and re-orientation. Here we use HS 6-digit data to identify, across SITC categories, the potential negative effects by sector and excluded country. The final chapter then looks at the possible impact of terms of trade changes stemming from the FTA, as discussed in Part I.

Overall, we find that:

- The dissimilarity of composition of export structures between the partners' exports to each other and excluded countries' exports to them suggests that the scope for negative effects arising from the EU–India agreement is relatively limited.

- The SAARC countries are, by a long way, the most vulnerable to negative impacts from the FTA. Their exports to the EU are more similar to India's and they are more dependent on the Indian market than are other countries. Among them, Bangladesh is the most exposed in the EU market, followed by Pakistan and Sri Lanka. However, the extent of the competitive edge that India gains from the FTA is, at least on average, relatively small. In the Indian market the most exposed are India's two landlocked neighbours, Bhutan and Nepal, at least if their varieties of export products compete directly with the EU's falling in the same heading. Here, the EU receives a huge competitive advantage, of about 20 per cent from the FTA, so the changes to trade patterns could be quite large.

- The BRICS (excluding India, of course) will generally experience trade diversion rather than trade re-orientation in the EU market, especially in manufacturing. Since the tariff preference for India is relatively small and the EU is not a predominant market for them, however, the effects will not be unmanageable. In the Indian market they suffer considerable competitive pressures from the improved access for the EU, but since they trade little with India, it is not of great significance in aggregate.

- ACP countries will mainly suffer from trade re-orientation as India receives preferences from the EU as deep as their own. They may also suffer from some form of trade diversion as a result of the EU getting enhanced access to India and possibly also in the EU market because, to the extent that they *de facto* face GSP rather than Cotonou tariff rates because they cannot satisfy the rules of origin for the latter. Again, with the exception of the Eastern and Southern Africa region, the effects of this will be small, given the extent to which their trade is concentrated in products for which India already receives zero tariffs in the EU and because their exports to either partner are relatively small.

- In both the EU and India the majority of the tariff lines that 'could' be affected by trade diversion or re-orientation are in the manufacturing sector, although in the EU the extent of diversion is likely to be larger in agriculture because protection is higher in this sector.

- In general the trade impacts are sufficiently small that excluded countries are unlikely to suffer serious terms of trade declines. The most vulnerable in this regard are India's neighbours – Bhutan, Nepal and Sri Lanka – in the Indian market, and Pakistan in the EU market.

A fifth possible section for this part would concern foreign direct investment – the extent to which the EU–Indian FTA might affect flows of investment to the member countries and, in particular, the extent to which it might influence (adversely) the flow of investment to excluded countries[29]. These effects are discussed in the literature to only a limited extent, and there are few concrete results or theorems on which to draw. Our estimate is that the effects are not likely to be very large – for the sort of reasons outlined in Schiff and Winters (2003) – and so we postpone discussion of investment effects until the next part on services trade. Even for services, we do not expect major effects, but they are arguably more important there than for goods.

Chapter 1

Trade similarity

In terms of changes in the volume of trade, the negative impact of the EU–India agreement on excluded countries can arise in two circumstances. The first negative impact is the well known trade diversion effect which occurs when non-preferential imports are replaced by preferential imports solely due to the preferences granted. The second negative impact arises through the 'correction' of existing trade diversion. This happens when the EU was importing from a preferential partner due solely to the preferences granted. Reducing tariff barriers with a new partner could re-orientate trade towards this new partner if it is more efficient in producing the given good. This is a gain for the EU in terms of efficiency, but a negative effect for preferential countries, who now lose their trade diversion advantage. An example of this is that if an agreement such as the EU-South Africa was already trade diverting, and if India were the least-cost producer, the EU–India FTA would change the direction of trade in favour of the latter, and although this would be to the EU's advantage, it would still harm South Africa. We refer to such outcome as the trade re-orientation effect.

Due to its reciprocal nature, the EU–India agreement is likely to have trade diversion and trade re-orientation effects from both the removal of EU tariff on India and Indian tariff on the EU.

The degree of import similarity by country of origin can shed light on the scope for both trade diversion and trade re-orientation. The more similar are import structures from proposed preferential partners to those that are non-preferential, the higher the risk of trade diversion or trade re-orientation. Hence, for example, if the structure of exports of India and Sri-Lanka to the EU were very similar, and India obtained preferential access, then this is more likely to impact on Sri-Lanka, than if the structure of their exports was quite different.

Table II.1 investigates this issue. The first column examines the similarity between imports from India and imports from the identified key partners by use of Finger-Kreinin indices of trade similarity for EU imports across all product categories at the HS 6-digit level of disaggregation[30]. The FK index ranges between zero (no similarity in trade structures) and one (identical structure of trade). The degree of similarity between EU imports from India and those from selected partners is in most cases low. We find a maximum FK of 0.269 for Sri Lanka which implies that Sri Lanka could suffer some loss of market share in the EU which could be due to either trade diversion and/or trade re-orientation. Similarly the similarity between the EU's imports from India and Pakistan is 0.259, and China 0.247[31].

In the second column we calculate the FK index for all tariff lines in which India faces a

positive tariff and hence will receive a competitive boost from the FTA[32]. This will give us an indication of the similarity of composition of EU imports from India with those from excluded countries in which there is a potential for *any* adverse effect arising from the agreement. In the third column, we calculate the FK index, but where we now take into account only those HS 6-digit industries where both India and the excluded country export to the EU, and where both India and the excluded country currently face a positive tariff. This in turn gives us an indication of the similarity of import composition of the EU from partners in lines which are likely to suffer from trade diversion possibly accompanied by some trade re-orientation. Hence, here we are identifying all those cases, where an EU–India FTA would improve India's access to the EU vis-à-vis the tariff currently being faced by the excluded country. This therefore covers both the possibility of trade diversion and/or trade re-orientation.

Take the case of Bangladesh, for example. Here we see that the overall FK index (column 1) suggests a low degree of similarity equal to 0.179. However, if we look at the second column, we can see that the degree of overlap between Indian exports to the EU and Bangladeshi exports to the EU in those cases where India currently faces a positive tariff, and thus excluded countries may be affected, is somewhat smaller (0.173). The third column then shows that there is no overlap between the exports of India and Bangladesh where both countries trade with the EU and face positive tariffs. This arises because Bangladesh's exports in principle already enter the EU duty-free under EBA preferences.

Table II.1. F-K index of import similarity between EU imports from India and imports from selected partners (2004)

	1	2	3
Afghanistan	0.058	0.052	0.000
Bangladesh	0.179	0.173	0.000
Bhutan	0.046	0.038	0.000
Maldives	0.016	0.013	0.000
Nepal	0.138	0.126	0.000
Pakistan	0.259	0.241	0.200
Sri Lanka	0.269	0.180	0.152
Brazil	0.161	0.105	0.046
Russia	0.073	0.039	0.008
China	0.247	0.205	0.106
South Africa	0.122	0.070	0.012
CARICOM	0.101	0.074	0.001
Central Africa	0.037	0.018	0.000
Eastern and Southern Africa	0.182	0.140	0.001
Pacific – EPA	0.031	0.013	0.002
SADC (less South Africa)	0.044	0.023	0.001
West Africa	0.056	0.034	0.001

Source: Author's calculations using Comtrade

This suggests that there is very little scope for trade diversion impacting negatively on Bangladesh. In turn, this suggests that any impact on Bangladesh's trade will thus arise from trade re-orientation. From the point of view of the EU's welfare this is positive, but nevertheless the impact on Bangladesh may still be substantial. This issue is explored in more detail later on. Overall, Columns 2 and 3 indicate that the scope for negative effects is greatest with regard to Pakistan, Sri Lanka and China.

Table II.2 carries out the same exercise as Table II.1 but looks at the degree of similarity between Indian imports from the EU and imports from excluded countries. The first column shows us that, except with regard to China, India imports very different goods from the EU than from the other excluded countries considered here. The FK indicators are all below 0.1, except with respect to China where there is considerably more overlap (FK = 0.242). This would suggest *a priori* that the scope for both trade diversion or trade re-orientation is small. It also suggests that the country that could be worst hit from Indian preferences granted to the EU would be China. The second and third panels show strong similarity between total import tariff lines and tariff lines that could be affected by trade diversion and/or trade re-orientation (this is seen from the similarity of FK between panels 1, 2 and 3). This occurs because India tends to have little zero tariff access from different countries in 2004 and has extended very few preferences.

Table II.2. F-K index of import similarity between Indian imports from the EU and imports from selected partners (2004)

	1	2	3
Afghanistan	0.008	0.008	0.008
Bangladesh	0.020	0.020	0.020
Bhutan	0.003	0.003	0.003
Maldives	0.014	0.014	0.014
Nepal	0.033	0.033	0.033
Pakistan	0.031	0.031	0.031
Sri Lanka	0.072	0.072	0.072
Brazil	0.085	0.085	0.085
Russia	0.095	0.094	0.094
China	0.242	0.239	0.239
South Africa	0.074	0.073	0.073
CARICOM	0.029	0.029	0.029
Central Africa	0.043	0.043	0.043
Eastern and Southern Africa	0.047	0.046	0.046
Pacific – EPA	0.010	0.010	0.010
SADC (less South Africa)	0.025	0.025	0.025
West Africa	0.031	0.031	0.031

Source: Author's calculations using Comtrade

Overall, the trade similarity indicators, which are based on the overall *structure* of trade, suggest that there is some scope for trade diversion to impact negatively for certain coun-

tries (Pakistan, Sri Lanka and China), and that there may be more scope for trade re-orientation (Bangladesh, Nepal, Brazil, South Africa, and Eastern and Southern Africa). The preceding, however, does not take into account country size effects. Given the size of the Indian economy and its trade with the EU, it is possible that size effects could dominate the structure effects. Hence, there may be products which are relatively unimportant in the structure of India's trade, but where the volume of that trade is sufficiently high that improved access to the EU market for India could impact significantly on the trade of other small or less developed countries. These issues are explored in more detail below, where we investigate, across tariff lines, the amount of excluded country exports that could be negatively affected as a result from improved market access between the EU and India.

Notes

29 Many of the trade effects discussed in the text will have investment implications – you can't expand production to take advantage of new opportunities from trade policy changes without investment – but popular discussion often presupposes that there are further, additional effects because an FTA changes the credibility of policy stances, the cost of investment goods etc. It is only to these that we are referring here, for otherwise we would be double-counting effects.

30 The F-K index of import similarity between country *m* and *n* can be defined, in general, as $FK_{mn} = \sum_i \min(\delta_{im}, \delta_{in})$. Where δ_{im} and δ_{in} are the share of imports from country *m* in product *i* and the share of imports from country *n* in product *i,* respectively. This index essentially captures the minimum share of trade by tariff line and then gives us an aggregate measure of the similarity of composition of imports from two different partners into one economy. As a point of reference, the FK index of export similarity between EU and US exports to the world stands at 0.61, which is considered high. At the other end of the spectrum, the FK index of export similarity between what the EU and the Central African region export to the world is 0.08 which is considered as being quite low.

31 The reader is warned that this is based on the assumption that trade patterns are not going to change and that 100 per cent of tariff lines are going to be liberalised in the EU–India agreement. If the latter condition does not hold, our number provides an upper estimate of such effect.

32 FK indices over a subset of headings have a maximum of below 1, so the interpretation is a little more tenuous. It is best to read them relative to the full FK in column (1) – i.e. how far does the commodity restriction discussed reduce similarity.

Chapter 2

Trade diversion and trade re-orientation: Aggregate analysis

In this section we look in much more detail at the potential loss of market access for excluded countries to either the EU or India arising from an EU–India FTA. For concreteness we consider the impact of improved Indian access to the EU market, but an exactly parallel analysis pertains to EU access to the Indian market. Here, there are four possible outcomes/scenarios:

- *No negative effect on excluded countries*: If prior to any FTA both the excluded country and India face zero tariffs (either because of GSP or EBA, or because the EU's MFN tariff is zero), then any agreement will not change the relative degree of access to the EU market for India.
- *Trade re-orientation effect*: This could occur when an excluded country already benefits from zero tariff access to the EU market, and the proposed preferential partner (India) matches this access through the agreement. Since India now has equal conditions of access to the European Union, there could be substitution across suppliers which would lead to increases in the market share of Indian competitors at the expense of other exporters to the EU. This effect will predominate mainly for excluded countries already benefiting from strong preferences in the EU, such as under EBA.
- *Trade diversion effect*: This could occur when, before preferences are granted, the proposed preferential partner (India) currently faces a tariff into the EU market *equal* to that faced by a excluded country. The removal of the tariff could lead to making the preferential partner a less costly supplier solely due to the preferences.
- *Trade re-orientation and trade diversion effect*: A combination of these two effects would occur when, before preferences are granted, the proposed preferential partner (India) faces a tariff into the EU market *greater* than that faced by excluded countries. The effect of the reduction in tariffs through the agreement can be surmised into two effects. The first would be a possible danger of trade re-orientation that would arise from the preferential partner matching the tariff of an excluded country (the magnitude of which could be determined by the absolute difference between the tariffs). The second would be a danger of trade diversion, the magnitude of which would depend on the height of the excluded country's tariff.

In order to explore these possibilities we compare the access by tariff line (at the 10-digit level) of each excluded country into the EU market against the access that the India may have after signing the agreement[33]. We also consider excluded country access to India compared to that of the EU. This enables us to measure the potential loss of access of excluded countries both to the EU market and to the Indian market.

It is important to note the role of efficiency in the above stated scenarios. In the second case, if India is the most efficient supplier of a given good, matching the preferences will result in trade re-orientation from previously inefficient sources towards Indian suppliers. This will result in an efficiency gain for the EU, but a loss to excluded countries due to the loss in market share as efficient Indian imports are replacing inefficient excluded country imports. If, on the other hand, India is not a more efficient supplier of a given good, then matching preferences should not result in changes in trade patterns with excluded countries[34]. In the event of scenario 3, if India is a less efficient supplier and the agreement improves its access to the EU market (where tariffs are maintained with excluded countries), there is scope for trade diversion since the European Union will import more from a less efficient country. On the other hand, if India is a more efficient supplier, it would have captured the market when it faced the same tariff as other suppliers and, any increases in trade would be creation.

There are also two practical data-related points to note in the exercises that follow. First, we have assumed that if they are eligible for reduced or zero tariffs in the EU, the excluded countries' exports actually get it. In fact, the rules of origin are tight and bureaucratically burdensome, so many exports from ACP countries or LDCs end up paying GSP rates when they are actually eligible in principle for better treatment. See for example Brenton (2003), or Augier et al. (2008 forthcoming) for evidence and discussion of these issues. Thus our estimates below tend to over-estimate trade re-orientation and underestimate diversion relative to the situation on the ground. Whether this means we mis-state the behavioural consequences is not quite so clear, however, for economic behaviour – e.g. decisions about investing and supplying the EU – may well respond to the *de jure* rather than the *de facto* situation.

Second, the data refer to 2004 or in some cases 2003. In both years India's exports of clothing and textiles were still constrained by the Multifibre Agreement. Hence any statistics relying on India's market share may understate the latter as it pertains to 2008 or later. There is little one can do about this, but the reservation should be recorded.

EU preferences

In the following analysis we have assumed that after the agreement, India will have immediate full tariff-free access to the European Union market in all product lines. This is an important assumption for two distinct reasons; (i) Under art XXIV of the WTO 'substantially all trade' tends to refer to 80 per cent of bilateral trade and; (ii) the 'reasonable amount of time' (Art XXIV) is commonly interpreted as 12 years. We assume 100 per cent *immediate* liberalisation. Given this assumption, our analysis does not allow us to address Indian tariff dismantling sequencing issues. This is important, for example, when we address the effects of the EU–India agreement on South Africa[35]. Our analysis is likely to overestimate the possible negative effects of the EU–India agreement on South Africa.

To address the possible negative effects that may arise from the EU–India agreement on excluded countries we carry out the following analysis. Using tariff lines at 10 digits, we

compare final Indian access to the European Union with the access that excluded countries benefit from under the different preferential schemes.

Table II.3 then classifies these according to each of the scenarios outlined above.

The first column of the table considers the role of GSP preferences. As India already benefits from GSP preferences, this suggests that for the remaining GSP countries who thus currently face the same access as India, there is only the possibility of trade diversion, and that the incidence of trade re-orientation would be zero. This is case 3 above. Similarly for countries facing MFN tariffs, matching preferences will not occur since these countries will be facing higher tariffs than India, the negative effects of the EU–India agreement on this grouping will occur only through trade diversion.

Table II.3 indicates that the GSP and MFN groups will either experience zero tariff (55 per cent of tariff headings currently have zero MFN tariff) or trade diversion since India will have better access than they do in just under 45 per cent of the 10-digit tariff lines.[36] In comparison, ACP and EBA countries are likely to suffer predominantly from trade re-orientation. For the ACP countries this covers up to 36.8 per cent of tariff lines, and for the EBA countries up to 44.4 per cent. This conclusion can also be extended to the case of South Africa although with some precaution given the implementation/sequencing issues discussed above.

Table II.3. Tariff lines affected by the EU–India FTA under different preferential schemes 2003

		GSP	EBA	ACP	South Africa	MFN
No change	Quantity of tariff lines	7795	7865	7795	7795	7795
	Per cent of total	55.1	55.6	55.1	55.1	55.1
Trade re-orientation	Quantity of tariff lines		6276	5198	3348	
	Per cent of total	–	44.4	36.8	23.7	–
Trade diversion	Quantity of tariff lines	6346		522	1498	6283
	Per cent of total	44.9	–	3.7	10.6	44.4
Trade re-orientation/diversion	Quantity of tariff lines			626	1500	
	Per cent of total	–	–	4.4	10.6	–
TOTAL		**14,141**	**14,141**	**14,141**	**14,141**	**14,141**

Source: UNCTAD-Trains database

While being informative, this analysis does not consider trading structures. If an excluded country is not exporting heavily in the identified tariff lines, the impact of the EU–India agreement on it will be small. For this reason, this analysis is to be interpreted as the maximum scope of preference erosion after the agreement. Table II.4A adds the trade dimension into this analysis[37]. For each of our countries and country groupings, it considers the share of trade with the EU which is accounted for by the four cases outlined earlier. Hence, the first row of the table indicates that 99.1 per cent of the value of Afghanistan's current

exports to the EU falls in products for which both Afghanistan and India currently face zero tariffs. An EU–India FTA would thus not improve India's relative access to the EU and is thus unlikely to have much impact on Afghanistan. The last column of the table also gives the share of the EU in Afghanistan's total exports, which in this case is 27 per cent.

The table therefore enables us to detail the possible impacts of an EU–India agreement according to the preferential scheme operating. In the case of GSP countries (Brazil, China, Pakistan and Sri Lanka), there will be no trade re-orientation from matching preferences (Case 2), and all the impact is characterised by trade diversion. Overall, the country most liable to be affected will be Pakistan since 78 per cent of its exports to the European Union will face increased competition from India, as we can see in column 3. This implies that, at most, up to US$ 2.3 billion of exports could be displaced by the agreement; meanwhile, nearly 21 per cent of its exports to the EU would be free of any effect as seen from column 2. These numbers are quite important in light of the fact that 25% of Pakistan's total exports go to the EU (column 6). Thus, in total, nearly 20 per cent of total Pakistani exports could be vulnerable to some form of trade diversion (i.e. 78.7% of 25%). Sri Lanka could also be heavily affected with over 58 per cent of exports to the EU facing some possibility of trade diversion. With regards to Brazil, China, and Russia, the affected trade could be up to 28 per cent, 23 per cent and 11 per cent of exports to the EU respectively, in which India would have better access to the EU market than they do[38].

A large part of the effects of the EU–India agreement on the small and poor countries of SAARC (Bangladesh, Afghanistan, Bhutan, Maldives and Nepal) will occur through India's matching their preferences in the EU (i.e. trade re-orientation). Here we see that the countries that could potentially be most severely hit would be Bangladesh and the Maldives: up to 97.5 per cent and 91.7 per cent respectively of their exports to the EU could be subject to increased competition from India (as we see from column 2), with the EU accounting for 62.4 per cent and 20.9 per cent of their total exports.

The exports to the EU of the ACP countries (West Africa, Central Africa, Eastern and Southern Africa, SADC, Caribbean and Pacific) fall mostly into the 'no change' category, but some could be affected both by trade re-orientation (matching preferences) and trade diversion (improved Indian access to the EU)[39]. The smallest impacts appear to arise in the case of West Africa and Central Africa, since over 80 per cent of their exports to the EU will not suffer any change in preferences. Eastern and Southern Africa will be affected more by trade re-orientation (54 per cent) as India matches their access to the European Union, than by trade diversion (9 per cent) as she obtains duty-free access while they do not. The highest threats of diversion arise for the Caribbean and the Pacific regions where 15 per cent and 18 per cent of their exports to the EU respectively may be affected. Finally, in the case of South Africa the likely negative impact will be of small magnitude. In fact, this analysis could be overestimating the effects of the better access of India since the EU-ZAF FTA is under implementation. As a consequence, there should not be better access for India with respect to South Africa.

If one is considering the impact of the EU–India FTA relative to the status quo for excluded countries, the distinction between re-orientation and diversion is moot: in both cases

excluded countries suffer deterioration in their current competitive position. The critical data are in column 1, which shows how much trade to the EU will be unaffected; its complement (i.e. 100% less column 1) tells us how much trade is vulnerable to a change in competitiveness.

The data in Table II.4A define an upper bound to the vulnerability of excluded countries' exports to the FTA. They are based on products for which (a) the target country has positive exports and (b) India will get a competitive boost from a decline in the tariff. They do not tell us, however, whether India is likely to take advantage of the decline in tariff. Of course, knowing that *a priori* is just impossible, but one indicator of whether India can actually produce the product in a form saleable in the EU is whether it actually has any exports to the EU. Some information on this is given in Table II.1, column 2, which tells us how similar India's and the target excluded country's exports to the EU are in cases where India faces a positive tariff. These suggest that there is often relatively little overlap and thus that Table II.4A may be over-estimating the degree of actual vulnerability.

To take an additional look at this we have, in Table II.4B, recalculated Table II.4A, but first applying a filter to exclude any products for which India's exports to the EU account for less than 0.25 (one-quarter) per cent of EU imports. We set the threshold above zero in order to try to exclude products which either have zero actual exports but have recorded trade because of one-off data recording errors or have very small amounts of quite exceptional trade. With an aggregate share of EU imports of about 1.5 per cent, this sets the threshold at one-sixth of India's average share, which seems a reasonable criterion for 'real' trade.

Because it refers to just a subset of the trade headings used in Table II.4A, this exercise naturally reduces the apparent vulnerability of excluded countries to the FTA, but to quite different extents across countries. Thus, for example, for Bangladesh the story hardly changes: in the bulk of trade headings it exports to the EU, India also exports, and the vast bulk of these are still subject to trade re-orientation because Bangladesh currently has tariff-free access while India does not. The filtered trade headings account for 58 per cent of Bangladesh's world-wide exports (as opposed to 62 per cent for her total exports to the EU). And the same applies to the other SAARC countries as well. Essentially, they export rather similar goods to the EU as India and so are more likely to be impinged upon by the new preferences for India.

Turning to the BRICs, however, we see that the filter actually excludes a lot of trade. In each case, well over half of their exports to the EU fall in headings for which India cannot manage even a small degree of market penetration. Moreover, in three of the four cases filtering by the Indian share significantly increases the share of trade for which we record 'no change'. Thus once we introduce the notion that India must be able to exploit the new tariff preferences, not merely receive them, the effects of the FTA on the BRICs seem to be a good deal smaller.

Finally, consider the ACP country groups. For the Caribbean and West Africa, the shares of world-wide exports that seem vulnerable to the FTA decline by factors of five and ten. In other words, through this lens the degree of overlap falls away dramatically, although

a higher share of those remaining in the vulnerable class face Indian tariff declines rather than 'no change'. For the other ACP groups, filtering halves (or more) the extent of vulnerable exports and increases the share of those remaining that are subject to no change. Again, once we ask whether India is a plausible competitor, the FTA appears much less challenging to the ACP countries than was implied by Table II.4A.

Of course, all this is predicated on the suggestion that if India does not currently export a good to the EU, it is not likely to do so significantly as a result of the FTA. This is not likely to be universally true, but neither is it likely to be grossly misleading.

Table II.4A. Value and percentage of exports to the European Union potentially affected by EU preferences to India under the EU–India FTA (by partner, in 2003, in US$ 000)

	1 No change		2 Trade re-orientation		3 Trade diversion		4 Trade re-orientation/ diversion		5 % share of export to EU out of total exports
	Value	% of total exports to EU	Value	% of total exports to EU	Value	% of total exports to EU	Value	% of of total exports to EU	
Afghanistan	55,592	99.1	482	0.9	–	–	–	–	27.0
Bangladesh	101,782	2.5	3,893,460	97.5		–	–	–	62.4
Bhutan	581	94.0	37	6	–	–	–	–	0.5
Maldives	1,945	8.3	21,627	91.7	–	–	–	–	20.9
Nepal	20,643	39.1	32,140	60.9	–	–	–	–	8.1
Pakistan	634,075	21.3	–	–	2,348,697	78.7	–	–	25.0
Sri Lanka	606,006	41.2	–	–	865,707	58.8	–	–	30.3
Brazil	14,594,890	74.4	–	–	5,034,075	25.6	–	–	26.9
Russia	43,958,076	92.1	–	–	1,650,391	3.5	2,134,377	4.5	35.7
China	75,525,180	71.4	–	–	30,204,056	28.6	–	–	24.1
South Africa	12,736,777	83.7	470,948	3.1	1,624,947	10.7	387,043	2.5	48.4
Caribbean	1,927,872	60.8	756,429	23.8	308,896	9.7	180,107	5.7	19.1
Central Africa	4,474,861	90.6	248,885	5.0	3,110	0.1	212,719	4.3	41.4
Eastern and Southern Africa	1,769,348	36.7	2,603,743	54.1	442,310	9.2	1,726	0	45.1
Pacific	362,068	61.2	120,412	20.4	108,875	18.4	13	0	7.9
SADC (no S Af)	3,741,448	73.6	1,152,674	22.7	98,799	1.9	89,395	1.8	65.6
West Africa	11,087,584	84.4	1,867,084	14.2	30,707	0.2	156,323	1.2	38.3

Source: UNCTAD-TRAINS database

Table II.4B. Value and percentage of exports to the European Union potentially affected by EU preferences to India for headings in which India's share of the EU imports exceeds 0.25% (by partner, in 2003, in US$ 000)

	1 No change		2 Trade re-orientation		3 Trade diversion		4 Trade re-orientation/ diversion		5 % share of export to EU in covered headings in total exports to world
	Value	% of total exports to EU in covered holdings	Value	% of total exports to EU in covered holdings	Value	% of of total exports to EU in covered holdings	Value	% of total exports to EU in covered holdings	
Afghanistan	36,299	98.9	401	1.1	0	0.0	0	0.0	17.7
Bangladesh	73,540	2.0	3,637,612	98.0	0	0.0	0	0.0	58.0
Bhutan	228	90.8	23	9.2	0	0.0	0	0.0	0.2
Maldives	655	9.8	6,021	90.2	0	0.0	0	0.0	5.9
Nepal	13,379	30.3	30,706	69.6	0	0.0	0	0.0	6.8
Pakistan	516,419	18.6	0	0.0	2,253,242	81.4	0	0.0	23.2
Sri Lanka	495,475	38.2	0	0.0	799,938	61.8	0	0.0	26.7
Brazil	5,427,169	76.7	0	0.0	1,646,677	23.3	0	0.0	9.7
Russia	5,764,793	90.4	0	0.0	199,021	3.1	413,212	6.5	4.8
China	28,793,466	62.1	0	0.0	17,606,495	37.9	0	0.0	10.6
South Africa	4,118,693	86.9	251,923	5.3	330,641	7.0	36,128	0.8	15.1
Caribbean	182,712	27.9	427,117	65.2	44,779	6.8	68	0.0	3.9
Central Africa	1,191,623	99.1	11,232	0.9	1	0.0	5	0.0	10.1
Eastern and Southern Africa	923,568	36.0	1,614,835	62.9	28,475	1.1	200	0.0	24.0
Pacific	208,470	86.1	33,547	13.9	0	0.0	0	0.0	3.2
SADC (no S Af)	2,215,674	95.1	111,813	4.8	2,100	0.1	108	0.0	30.1
West Africa	937,688	69.4	405,927	30.0	8,215	0.6	137	0.0	3.9

Source: UNCTAD-TRAINS database.

India Preferences

We now turn to the analysis of the effects of the EU–India agreement on excluded countries that could arise from the concession of Indian preferences to the EU. The analysis is similar to the preceding insofar as we assume that the effects on excluded countries will arise from the type of concessions already granted to excluded countries, and how these will be matched/improved for the EU. To this end, Table II.5 investigates the number of tariff lines at 8 digit level that could be threatened by increased EU competition in the Indian market[40].

For this analysis, we distinguish according to the preferential schemes that India operates.

India applies preferential tariffs to its SAARC (SAFTA) partners; however, it differentiates across SAARC partners according to levels of development. In Table II.5, SAARC (LDC) refers to Bhutan and Nepal[41], whereas the SAARC preference grouping comprises; Pakistan and the Maldives. The preferences granted to the SAARC LDCs outstrip those of the other SAARC members. There are also special preferential agreements in place with Afghanistan, Bangladesh and Sri-Lanka.

Further to these preferences, India extends a Global System of Trade Preferences (GSTP) to developing countries. Much like the EU GSP, the GSTP provides differential access to the Indian market according to the level of development. We distinguish between these in Table II.5.

Table II.5. Tariff lines affected by the EU–India FTA under different preferential schemes (2005)

	Afghanistan	Bangladesh	Sri Lanka	SAARC (LDC)	SAARC	GSTP (LDC)	GSTP	MFN
No change								
Quantity of tariff lines	287	287	287	287	287	287	287	287
Percentage of total	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
Trade re-orientation								
Quantity of tariff lines	313	481	9121	291	0	0	0	0
Percentage of total	2.7	4.1	78.0	2.5	0.0	0.0	0.0	0.0
Trade diversion								
Quantity of tariff lines	5,644	5,455	833	5,633	9,662	11,221	11,221	11,406
Percentage of total	48.3	46.7	7.1	48.2	82.6	96.0	96.0	97.5
Trade re-orientation/diversion								
Quantity of tariff lines	5,449	5,470	1,452	5,482	1,744	185	185	0
Percentage of total	46.6	46.8	12.4	46.9	14.9	1.6	1.6	0.0
TOTAL	**11,693**	**11,693**	**11,693**	**11,693**	**11,693**	**11,693**	**11,693**	**11,693**

Source: UNCTAD-TRAINS database.

Overall, Table II.5 suggests that a large proportion of tariff lines across selected partners potentially suffer from increased competition from the EU in their access to the Indian market. This arises from the low level of preferences that are currently being granted by India to excluded countries (except Sri Lanka). For Afghanistan and Bangladesh, the EU would match current access to the Indian market in around 5 per cent of tariff lines, but if there was complete liberalisation of tariffs between the EU and India, it would have better market access in over 95 per cent of tariff lines. In the case of SAARC countries, we see that preferences are granted only on 1744 tariff lines and, in fact, these offer only small reductions in the tariff rates of these lines. The EU is likely to surpass SAARC partner's market access in India in over 97 per cent tariff lines. Compared to other SAARC

partners, SAARC LDCs benefit from a few more concessions in the form of 291 tariff lines gaining zero tariff entry to India, and from reduced tariffs in 4,029 products[42]. The EU will improve its access to India over these countries in 95 per cent of tariff lines. With regards to GSTP countries, who benefit from lower tariffs in 185 products, the EU will also significantly increase its market access to the Indian Market. India's only 'serious' FTA to date is with Sri Lanka, and here the predominant effect is trade re-orientation since the European Union will match its preferential access to the Indian market in nearly 78 per cent of the tariff lines.

Overall, the potential impact of extending preferential market access to the Indian market for the EU could have important implications for excluded countries in terms of tariff line access to India. However, the true effect will depend on how strongly these excluded countries export to India in the identified lines. As before, Table II.6A, adds a trade dimension to the above tariff exercise to try to provide upper bound estimates of the effects of Indian tariff liberalisation with respect to the EU on excluded countries. Once again we distinguish across the four scenarios identified at the beginning of this section.

We suggest that the size of the effects on excluded countries of India granting preferences to the EU will depend largely on the value of their exports to India and on the degree of comparative market access enjoyed by the EU as a result of these preferences. From Table II.6A, we see that the countries whose exports are most heavily concentrated on India are Bhutan and Nepal (column 5). Granting EU exports better access to India is likely to increase competition and could negatively impact these countries. The amount of 'affected trade' could be over 90 per cent of Bhutan's exports to India and 60 per cent of Nepal's exports to India[43]. We see that this negative impact will come in the form of both trade diversion and trade re-orientation. Following this logic, the effects on Sri Lanka and Afghanistan would be smaller, with those for Bangladesh, the Maldives and Pakistan being negligible. It is important to note that, even at this high level of disaggregation, the products produced by the EU could be qualitatively different from those produced by excluded developing countries and we thus might be over-estimating the degree of competitive threat that the latter face[44].

With regards to the ACP countries, Table II.6A suggests that exports to India are very small, and that even though the EU will gain better access to the Indian market in over 99 per cent of tariff lines, the negative impact will be very small. This can also be extended to BRICS whose share of exports to India is small, with the mild exception of South Africa.

Overall, Table II.6A suggests that Indian preferences granted to the EU will impact most heavily on Bhutan and Nepal. However, given that the similarity of EU exports to India with Bhutanese and Nepalese exports to India is low (as shown in Table II.2), the overall negative effect is likely to be small[45]. Thus, even though the EU, as a result of the EU–India agreement, will have a much better access to India than any partner country analysed, the negative impact on excluded countries is likely to be muted due to the dissimilarity in export structures and the slight importance of exports to India in excluded countries' total exports.

Table II.6A. Value and percentage of exports to India potentially affected by Indian preferences to EU under the EU–India FTA (by partner, in 2005, in US$ 000)

	1 No change		2 Trade re-orientation		3 Trade diversion		4 Trade re-orientation/ diversion		5 % share of export to India in total exports
	Value	% of total exports to IND	Value	% of total exports to IND	Value	% of total exports to IND	Value	% of total exports to IND	
Afghanistan	474.2	0.8	20,385.3	35.0	12,370.6	21.3	24,966.8	42.9	28.0
Bangladesh	685.2	0.5	4,824.4	3.8	47,051.8	36.9	74,929.4	58.8	2.0
Bhutan	72.6	0.1	28,055.8	24.1	29,272.8	25.2	58,810.5	50.6	99.0
Maldives	0	0	0	0	1,968.6	99.3	13.3	0.7	1.8
Nepal	1,120.6	0.3	30,009.4	7.3	187,020.8	45.5	193,073.4	47	63.0
Pakistan	17.3	0	0	0	52,731.5	29.3	127,444	70.7	1.5
Sri Lanka	3,404.3	0.3	553,258	48.8	13,991.5	1.2	562,008.5	49.6	23.3
Brazil	10,563.7	1.2	0	0	862,576.5	97.7	9,336.5	1.1	1.2
Russia	2,923,150.7	27.1	0	0	7,784,072.2	72.1	92,809	0.9	2.5
China	2,630.7	0.1	0	0	2,014,980.7	99.9	0	0	1.5
South Africa	2,988.1	0.1	0	0	2,295,329.5	92.5	182,622.4	7.4	7.9
Caribbean	82.2	0.2	0	0	35,046.8	92.8	2,641	7	0.2
Central Africa	38.8	0	0	0	113,014.8	99.9	27.2	0	0.9
Eastern and Southern Africa	6,849.3	3.5	0	0	184,660.1	95.4	2,112.7	1.1	1.8
Pacific	132	0	0	0	295,538.9	99.8	448.3	0.2	4.0
SADC (no S Af)	452.5	0.2	0	0	197,228.5	99.6	380.9	0.2	2.6
West Africa	2,009.6	0.2	0	0	773,900.1	72.6	289,889.7	27.2	3.1

Source: UNCTAD-TRAINS database

To check these hypotheses further, we also applied the same market presence filter to Table II.6A as to Table II.4A: that is we re-calculated Table II.6A excluding any heading for which the EU did not provide at least 0.25 per cent of Indian imports. (In this case, the threshold is about one hundredth of the EU's average share.) As with the previous table, this necessarily reduces the share of world-wide exports that appear to be vulnerable to the FTA. In the cases of the BRICs and the ACP countries, this reduces small numbers to very small ones and so hardly changes the situation qualitatively. Similarly for Bangladesh, the Maldives and Pakistan. For the remaining SAARC countries, however, the changes are more significant. For Afghanistan and Sri Lanka, the filtering basically eliminates the cause for concern: for the former, there is no vulnerability, whereas for the latter only 5 per cent of total exports look vulnerable. For Bhutan and Nepal, filtering reduces very high figures to merely high ones: even with the filter, a significant share of

their total exports would face a strong increase in competition from the EU in India, although, as we have noted above, this ignores any differences in quality between EU and the SAARC countries' varieties.

Table II.6B. Value and percentage of exports to India potentially affected by Indian preferences to the EU for headings in which the EU's share of Indian imports exceeds 0.25% (by partner, in 2005, in US$ 000)

	1 No change		2 Trade re-orientation		3 Trade diversion		4 Trade re-orientation/ diversion		5 % share of export to India in covered headings in total exports to world
	Value	% of total exports to India in covered headings	Value	% of total exports to India covered headings	Value	% of total exports to India covered headings	Value	% of total exports to India covered headings	
Afghanistan	474	30.4	0	0.0	136	8.7	948	60.8	0.8
Bangladesh	685	1.8	4,444	11.8	4,109	10.9	28,562	75.6	0.6
Bhutan	–	0.0	28,056	41.6	28,594	42.4	10,766	16.0	57.5
Maldives	–	0.0	–	0.0	1,340	69.6	586	30.4	1.7
Nepal	943	0.5	8,189	4.6	81,500	46.0	86,384	48.8	27.1
Pakistan	17	0.0	–	0.0	40,420	84.9	7,151	15.0	0.4
Sri Lanka	3,404	1.2	262,359	92.0	10,330	3.6	9,159	3.2	5.9
Brazil	10,564	3.5	–	0.0	270,008	88.8	23,457	7.7	0.4
Russia	2,630	0.1	–	0.0	1,787,424	99.2	12,603	0.7	0.4
China	2,915,412	36.3	–	0.0	4,921,549	61.2	199,126	2.5	6.0
South Africa	2,988	0.2	–	0.0	1,973,246	99.7	2,148	0.1	6.3
Caribbean	82	0.4	–	0.0	22,391	97.4	509	2.2	0.1
Central Africa	39	0.1	–	0.0	74,839	99.5	367	0.5	0.6
Eastern and Southern Africa	6,849	5.3	–	0.0	121,495	93.7	1,375	1.1	1.2
Pacific	132	0.1	–	0.0	255,075	99.9	43	0.0	3.4
SADC (no S Af)	452	0.7	–	0.0	67,657	99.1	137	0.2	0.9
West Africa	2,010	0.5	–	0.0	364,219	99.0	1,847	0.5	1.1

Source: UNCTAD-TRAINS database

Notes

33 This analysis excludes cross-product effects (i.e. the tariff on good *i* affecting trade in good *j*) and general equilibrium effects of tariff reductions. This means, for example, that a tariff reduction in wheat does not affect trade in, say, rice. We also assume that tariff liberalisation of the EU–India agreement will be of 100 per cent.

34 Assuming perfect competition and perfect substitutability between origins of imports.

35 EU tariff dismantling on South African products used in this study are from 2003 and are sequenced, implying that they encapsulate planned reduction for 2003.

36 In the case of MFN countries, percentages do not add 100 since we have not considered those tariff lines in which the preference rate was higher than the MFN tariff in TRAINS database.

37 We have aggregated the results obtained at 10 digits into 6 digits in order to match the tariffs lines with trade values.

38 In the case of Russia, it is important to note that we assume that Russia faces the EU's MFN tariff since it is not under any preferential scheme.

39 We have used here the 'Preferential for ACP countries' definition on TRAINS, which, so far as we can see, refer to Cotonou preferences (i.e. Lome IV until 2007)

40 In this analysis, we assume that trade liberalisation will be immediate and will cover 100 per cent of EU goods. The level of disaggregation was constrained by data availability.

41 Even though Bhutan and Nepal have preferential access to the Indian market, this is mainly concentrated in goods that are transiting. Both partners have signed Trade and Transit agreements with India. These treaties suppose free trade, however, there does not seem to be a formal accord. For the purposes of the study and in the absence of conclusive evidence, we assume that preferences granted to these two partners follow the SAARC LDC preferences which are, in turn, informed from TRAINS database.

42 Tariff is above zero but below MFN.

43 Bhutan and Nepal are landlocked, of course, and there may well be confusion between their exports to India and those merely transiting India to other destinations. Thus, these proportions may be misleading.

44 Information on prices in the affected tariff lines could help us to differentiate across qualities, and so cast light on this issue. Unfortunately such data are not readily accessible and would require a separate research exercise.

45 Bhutan and Nepal are important exporters of electricity to India. In Bhutan, electricity exports to India account for 25 per cent of GDP (Bernard and McKechney, 2007). These values are not recorded in our statistics. However, it is highly unlikely that the EU–India agreement would affect these sectors.

Chapter 3

Trade diversion and trade re-orientation: Sectoral analysis

One can further decompose the potential impacts of the EU–India agreement into different sectors. In this chapter we approach this issue by identifying tariff lines for which there are positive trade values from excluded countries and in which the preferential partner could match or surpass the excluded countries' access to the target market. In essence, we now investigate all the scenarios analysed above with the exception of scenario 1 by SITC rev. 3 sectors. The analysis is carried out at 6-digits HS level, and then aggregated to SITC categories[46].

EU preferences

Table II.7 counts the number of tariff lines in which EU tariffs on India are positive and both the excluded country and India export to the EU. These are the tariff lines most likely to be adversely affected by the preferential agreement, and we refer to them below by the short-hand 'affected' headings. These headings suffer possible trade re-orientation, trade diversion or a mix of both (scenarios 2, 3 and 4) according to SITC rev. 3 sectors. By filtering the tariff differential for positive trade values (i.e. only recording tariff differentials that have positive trade values from the proposed sample), we can identify the tariff lines across partners that are likely to suffer from some form of negative effect[47]. The shaded rows mark the share of the given SITC sector in the total number of tariff lines that are affected. The penultimate row of Table II.7 reports the share of 'affected' tariff lines for which the excluded country faces a zero tariff; this allows us to differentiate the pure trade re-orientation effect from the 'trade diversion and/or trade re-orientation' effects. The final row expresses the excluded countries' number of 'affected' tariff lines as a percentage of the total number of tariff lines for which it records positive exports to the EU.

Table II.7 suggests that the potential negative effects of the EU–India agreement are largely concentrated in the manufacturing sectors (SITC sectors 6, 7 and 8). These are more likely to occur geographically; in SAARC countries for Pakistan and Sri Lanka; in BRICS countries for China, Brazil and Russia; and in ACP groupings for the Pacific. Table II.7 also shows, to a lesser degree, some potential negative effects arising in the 'food and live animals' sector for China, Sri Lanka, Russia and Pakistan. Furthermore, the share of tariff lines that are zero, suggests, for SAARC countries with the exception of Pakistan and Sri Lanka, that the dominating effect will be that of trade re-orientation (scenario 2).

Table II.7: Tariff lines that could be affected by extension of preferences to India (2004)

SITC description	Afghanistan	Bangladesh	Bhutan	Maldives	Nepal	Pakistan*	Sri Lanka	Brazil	Russia	China	South Africa	CARICOM	Central Africa	East and Southern Africa	PACIFIC	SADC	West Africa
0 Food and live animals	8	51	1	8	10	83	95	134	113	154	118	106	48	124	28	61	130
%	6.9	6.8	2.0	8.2	2.0	5.5	9.0	5.7	4.7	5.2	5.4	10.1	6.5	8.7	7.3	9.1	9.8
1 Beverages and tobacco		3				4	3	5	6	6	4	6	3	6	1	1	5
%	0.0	0.4	0.0	0.0	0.0	0.3	0.3	0.2	0.2	0.2	0.2	0.6	0.4	0.4	0.3	0.1	0.4
2 Crude materials, except fuels	3	2			6	20	17	34	29	43	29	18	14	23	11	11	22
%	2.6	0.3	0.0	0.0	1.2	1.3	1.6	1.5	1.2	1.5	1.3	1.7	1.9	1.6	2.9	1.6	1.7
3 Fuels and lubricants	1	2				2	1	5	6	5	6	2	1	3	1	2	1
%	0.9	0.3	0.0	0.0	0.0	0.1	0.1	0.2	0.2	0.2	0.3	0.2	0.1	0.2	0.3	0.3	0.1
4 Oils, fats and waxes		2			1	3	4	17	11	17	8	7	5	12	7	4	13
%	0.0	0.3	0.0	0.0	0.2	0.2	0.4	0.7	0.5	0.6	0.4	0.7	0.7	0.8	1.8	0.6	1.0
5 Chemicals	2	18	1	2	10	69	43	321	371	492	278	79	30	80	17	24	85
%	1.7	2.4	2.0	2.0	2.0	4.5	4.1	13.7	15.4	16.8	12.8	7.5	4.1	5.6	4.5	3.6	6.4
6 Manufactured goods classified by material %	24	221	12	6	153	609	304	715	729	967	686	195	167	380	61	169	348
	20.7	29.5	23.5	6.1	30.6	40.1	28.7	30.6	30.3	32.9	31.5	18.6	22.6	26.6	16.0	25.1	26.2

*Pakistan benefited from special treatment under the GSP anti-trafficking arrangement in 2004, values reported are 2006 tariffs.

Calculations at HS 6 digits and aggregated up.

Table II.7: Tariff lines that could be affected by extension of preferences to India (2004) continued

SITC description	Afghanistan	Bangladesh	Bhutan	Maldives	Nepal	Pakistan*	Sri Lanka	Brazil	Russia	China	South Africa	CARICOM	Central Africa	East and Southern Africa PACIFIC	SADC	West Africa
7 Machinery and transport goods	34	93	22	31	24	256	191	543	573	609	521	296	255	349	117	210	378
%	29.3	12.4	43.1	31.6	4.8	16.8	18.0	23.2	23.8	20.7	24.0	28.2	34.6	24.4	30.7	31.2	28.4
8 Miscellaneous manufactures	44	356	15	51	296	474	403	563	569	644	525	342	215	452	138	192	347
%	37.9	47.6	29.4	52.0	59.2	31.2	38.0	24.1	23.6	21.9	24.1	32.5	29.1	31.6	36.2	28.5	26.1
9 Commodities not elsewhere classified %	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total affected tariff lines	116	748	51	98	500	1520	1061	2337	2407	2937	2175	1051	738	1429	381	674	1329
% share of affected tariff lines that face zero	100	98.7	100	100	98	44.5	45.5	54.9	56	52.2	85	98	98.5	98.2	86.6	98.4	98.1
% share of affected lines in total tariff lines traded	66.3	80.3	67.1	75.4	80.1	78.9	77.4	68.3	64.5	64.4	67.6	68.8	69.2	70.1	73.0	68.9	68.4

*Pakistan benefited from special treatment under the GSP anti-trafficking arrangement in 2004, values reported are 2006 tariffs.

Calculations at HS 6 digits and aggregated up.

Source: COMTRADE, TRAINS, own calculations.

Calculations at HS 6 digits and aggregated up.

The magnitude of the effects on excluded countries of granting India preferential access to the EU is also likely to depend on the height of tariffs. Table II.8 reports the unweighted average tariff faced by India in the headings relevant for each excluded country/SITC section. This measures the size of the 'shock' generated by eliminating the tariff on India. Table II. 9, on the other hand, reports the average tariff remaining on the excluded countries, i.e. the extent of India's preferences in the lines affected (since we assume that India faces a tariff of zero on all lines). These influence the effects on excluded countries relative to a norm of non-discriminatory trade rather than their initial positions[48]. In Table II.8, we see that average tariffs in the EU are low, suggesting that the magnitude of the effects is likely to be small. Table II.7 identified the manufacturing sectors as particularly sensitive, but Table II.8 suggests that the potential negative effects could be very small in these sectors given the low tariffs. Average tariffs on 'food and live animals' tend to be higher than those for manufacturing, suggesting, in conjunction with Table II.7, that the negative effects identified for Sri Lanka, Pakistan and the BRICS countries could be more pronounced in this sector. Identified tariffs seem to be highest in the 'Beverage and Tobacco' sector, but the small number of affected lines points to little trade diversion or trade re-orientation in this sector.

The magnitude of the effects of the EU–India agreement on excluded countries will also depend on the value of excluded countries exports to India that are affected. These are identified in Table II. 10 where we look at the share of affected exports by SITC rev. 3 sector relative to the excluded countries' total exports to the EU. This will give us a sectoral decomposition of trade which can be used in conjunction with the tariff levels in Table II.8 and Table II.9 to assess the size of the likely shocks to excluded country trade and the degree of discrimination they will face when the FTA is implemented. We further contextualise these results by giving in the last row, the share of affected exports to the EU in total exports to the world for excluded countries[49].

Table II.7 suggested that the SAARC countries that could be most affected by Indian preferences to the EU market are Pakistan and Sri Lanka. For Pakistan, we see from Table II.10 that the bulk of exports to the EU is in SITC sectors 6 and 8 ('manufactured goods' and 'miscellaneous manufactures'). These sectors comprise most textile exports and exhibit tariffs of around 3-4 per cent which implies that there is some scope for negative effects arising from trade diversion in these sectors. Furthermore, the EU export market represents over 33 per cent of total Pakistani exports implying that these effects could impact on a significant proportion of the economy, although the tariffs here are typically low. In the case of Sri Lanka, we see that exports are largely concentrated in 'miscellaneous manufactures' which also represent an important share of total Sri Lankan exports, and which could be subject to increased competition in the EU market. Thus, for the larger SAARC countries, Table II.10 suggests that material negative consequences of the EU–Indian FTA are more than just conceivable.

The last row of Table II.10 shows that the BRICS tend to export a lower percentage of their total trade to the EU, suggesting that the negative effects of the EU–India agreement will be of small magnitude relative to their overall economies. They will, however, be concentrated in the manufacturing sectors (SITC sectors 6, 7 and 8). The ACP countries, on the

Table II.8. EU tariffs on India for positive third country exports to the EU (2004)

SITC description	Afghanistan	Bangladesh	Bhutan	Maldives	Nepal	Pakistan*	Sri Lanka	Brazil	Russia	China	South Africa	CARICOM	Central Africa	East and Southern Africa PACIFIC	SADC	West Africa
0 Food and live animals	6.2	6.4	3.6	8.6	3.6	6.5	7.0	7.9	9.2	7.7	7.8	7.1	6.2	7.4	6.4	8.0	7.9
1 Beverages and tobacco	2.9	4.3	22.7	0.0	2.4	3.9	6.5	5.5	8.6	9.7	8.2	10.1	1.9	7.6	3.3	3.5	8.9
2 Crude materials, except fuels	0.3	0.4		0.0	0.6	0.5	0.5	0.4	0.3	0.4	0.4	0.5	0.2	0.4	0.5	0.5	0.3
3 Fuels and lubricants	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
4 Oils, fats and waxes		2.9			2.7	3.7	3.0	2.1	1.8	2.9	2.3	3.1	1.8	2.4	2.4	2.4	3.3
5 Chemicals	1.0	0.4	1.0	1.6	0.2	1.1	0.5	1.1	1.0	1.1	0.8	1.2	1.1	1.0	0.7	2.1	1.0
6 Manufactured goods classified by material	2.3	3.9	2.6	3.7	3.3	3.6	3.0	2.2	1.9	2.5	2.2	2.2	1.6	2.7	1.6	2.3	2.7
7 Machinery and transport goods	0.4	0.6	0.1	0.3	0.3	0.4	0.3	0.4	0.4	0.3	0.4	0.3	0.4	0.5	0.3	0.3	0.4
8 Miscellaneous manufactures	3.8	5.3	4.4	5.4	5.3	4.1	4.6	3.2	3.1	3.1	2.8	3.3	2.9	3.7	3.7	3.3	3.1
9 Commodities not elsewhere classified		0.0					0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		0.0
Average	2.3	4.1	3.4	3.7	4.1	3.3	3.4	2.3	2.1	2.3	2.1	2.5	1.9	2.8	2.3	2.7	2.8

*Pakistan benefited from special treatment under the GSP anti-trafficking arrangement in 2004, values reported are 2006 tariffs.

Calculations at HS 6 digits and aggregated up.

Table II. 9. Average Tariffs on excluded countries per 'affected' line (2004)[50]

SITC description	Afghanistan	Bangladesh	Bhutan	Maldives	Nepal	Pakistan*	Sri Lanka	Brazil	Russia	China	South Africa	CARICOM	Central Africa	East and Southern Africa	PACIFIC	SADC	West Africa
0 Food and live animals	0.00	0.15	0.00	0.00	0.00	6.0	6.93	6.41	7.45	7.00	5.43	0.49	0.22	0.39	1.31	0.27	0.47
1 Beverages and tobacco		0.00				13.98	13.01	7.10	19.58	19.58	0.00	0.00	0.00	0.00	23.40	0.00	0.00
2 Crude materials, except fuels	0.00	2.10			0.70	2.30	1.92	1.92	1.83	2.11	0.88	0.23	0.00	0.18	0.38	0.38	0.19
3 Fuels and lubricants	0.00	0.00				0	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
4 Oils, fats and waxes		0.00			0.00	4	2.22	1.91	2.82	2.79	0.47	0.00	0.00	0.00	0.00	0.00	0.00
5 Chemicals	0.00	0.00	0.00	0.00	0.00	0.76	0.91	0.71	0.93	0.92	0.04	0.00	0.00	0.00	0.32	0.00	0.00
6 Manufactured goods classified by material	0.00	0.05	0.00	0.00	0.03	3.94	3.09	3.49	2.90	3.34	0.45	0.02	0.03	0.03	0.50	0.03	0.02
7 Machinery and transport goods	0.00	0.00	0.00	0.00	0.00	0.30	0.40	0.40	0.40	0.38	0.13	0.00	0.00	0.00	0.23	0.00	0.00
8 Miscellaneous manufactures	0.00	0.05	0.00	0.00	0.09	4.77	3.98	5.20	3.84	3.84	0.44	0.03	0.06	0.04	0.91	0.02	0.04
9 Commodities not elsewhere classified																	
Average	0.00	0.05	0.00	0.00	0.07	3.55	2.59	3.71	2.46	2.63	0.59	0.07	0.04	0.06	0.66	0.04	0.07

Source: COMTRADE, TRAINS, own calculations.

*Pakistan benefited from special treatment under the GSP anti-trafficking arrangement in 2004, values reported are 2006 tariffs.

Table II. 10. Share of bilateral trade with the EU possibly affected from extension of preferences to India (2004)

SITC description	Afghanistan	Bangladesh	Bhutan	Maldives	Nepal	Pakistan*	Sri Lanka	Brazil	Russia	China	South Africa	CARICOM	Central Africa	East and Southern Africa	PACIFIC	SADC	West Africa
0 Food and live animals %	2.79	3.81	0.09	94.40	0.09	1.53	2.62	3.35	0.61	0.88	5.29	9.26	5.40	22.42	7.67	6.41	12.35
1 Beverages and tobacco %	0.00	0.00	0.00	0.00	0.00	0.01	0.03	0.01	0.00	0.00	0.02	1.12	0.00	0.03	0.00	0.00	0.01
2 Crude materials, except fuels %	0.10	0.00	0.00	0.00	0.12	0.06	0.45	1.38	0.08	0.24	0.65	12.10	8.91	8.54	0.35	0.08	2.39
3 Fuels and lubricants %	0.00	0.00	0.00	0.00	0.00	0.00	0.01	0.34	11.35	0.03	0.31	6.40	0.43	0.22	0.00	0.08	0.08
4 Oils, fats and waxes %	0.00	0.00	0.00	0.00	0.00	0.00	0.01	0.13	0.00	0.02	0.03	0.01	0.01	0.08	35.11	0.03	0.38
5 Chemicals %	0.07	0.00	5.82	0.05	0.27	1.86	0.31	2.56	1.25	2.15	1.87	2.12	0.71	0.44	0.09	0.02	0.03
6 Manufactured goods classified by material %	8.99	4.86	1.97	0.07	49.20	44.56	9.05	9.47	3.85	9.00	8.51	0.43	5.49	3.80	0.11	18.51	2.82
7 Machinery and transport goods %	2.77	0.45	3.48	1.07	1.67	0.89	5.68	9.78	0.62	20.11	15.03	2.55	0.35	0.93	0.65	0.59	0.32
8 Miscellaneous manufactures %	1.68	89.44	6.15	1.08	38.49	41.02	62.17	2.46	0.37	28.90	3.80	3.83	0.16	18.40	0.62	0.37	0.28
9 Commodities not elsewhere classified %	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
% share of trade with EU	16.39	98.57	17.51	96.67	89.85	89.92	80.33	29.49	18.15	61.33	35.52	37.82	21.47	54.86	44.60	26.09	18.65
% share of total trade	3.05	57.50	0.27	16.69	16.84	33.43	28.85	7.79	9.67	12.44	13.25	6.68	6.02	19.27	7.72	7.94	5.15

Source: COMTRADE, TRAINS, own calculations.

*Pakistan benefited from special treatment under the GSP anti-trafficking arrangement in 2004, values reported are 2006 tariffs.

Calculations at HS 6 digits and aggregated up.

other hand, export mainly primary goods to the EU (SITC sectors 0, 1 and 2) – see rows 1-3 of Table II.10. The tariffs they face on these goods are quite low, suggesting that the effects of Indian preferences in the EU will mainly arise from trade re-orientation, but this is of little comfort to the exporters who merely see a policy-induced decline in their competitveness. Out of this grouping, ESA is most likely to suffer the consequences of the agreement because the EU is an important export market for agricultural goods. The overall effects will, nonetheless, depend on the degree of similarity/substitutability between ESA exports and Indian exports in this sector.

India preferences

Increased EU preferences in the Indian market will also have an effect on excluded countries. This section looks at the possible negative impacts that could arise from these concessions. Table II.11 mimics Table II.7 in its procedure of identification of 'affected' tariff lines. It counts the number of tariff lines in which Indian tariffs on the EU are positive and both the excluded country and the EU export to India. Thus it again seeks to identify the tariff lines most likely to be adversely affected by the preferential agreement.

Table II.11 suggests that the negative effects could be concentrated in the manufacturing sectors (SITC sectors 6, 7 and 8) which see the highest share of 'affected' tariff lines. In SAARC countries, this could be more pronounced for Nepal, Pakistan and Sri Lanka. The highest effects will hit the BRICS which see a large share of tariff lines 'affected' and, to a lesser extent, the African members of the ACP. Table II.11 also confirms that Indian current preferences are low (as seen in table II.5), as seen by the small share of tariff lines that are zero; this suggests that the predominant effect will be that of trade diversion (scenario 3).

The negative effects of preferences India grants to the EU will also depend on the height of the Indian tariffs levied on the EU. Table II.12 looks at EU average (unweighted) tariffs across SITC sectors for the affected tariff lines. Here we see that Indian tariffs are considerably higher than those of the EU (comparing Table II.8 and Table II.12). For 'beverages and tobacco' we note tariffs nearing the 100 per cent; however, from Table II.11 we see that only a small proportion of tariff lines will be affected in this sector. Tariffs on manufactured goods are in the region of 25 per cent and this, combined with the number of lines that could suffer from increased competition (as shown in Table II.11), suggests that the negative effects on excluded countries of Indian preferences to the EU would be largely concentrated in manufacturing goods (SITC sectors 6, 7 and 8).

As we did above with respect to the tariff that excluded countries will face on the EU after India gains access to that market, Table II.13 reports the unweighted average tariff remaining on the excluded countries faced in the Indian market. It can be seen that the tariff differential with respect to the gained access to the Indian market by the EU, is substantially high.

Table II.11. Tariff lines that could be affected by extension of preferences to EU (2004)

SITC description	Afghanistan	Bangladesh	Bhutan	Maldives	Nepal	Pakistan*	Sri Lanka	Brazil	Russia	China	South Africa	CARICOM	Central Africa	East and Southern Africa	PACIFIC	SADC	West Africa
0 Food and live animals	8	33	2	1	56	32	26	19	4	70	59	3		14	1	4	9
%	21.1	15.4	5.1	11.1	9.6	9.4	3.3	2.2	0.7	2.1	5.8	3.8	0.0	4.2	5.0	10.8	4.2
1 Beverages and tobacco	1	3	3		3	1	7	1	3	14	5	4		4			3
%	2.6	1.4	7.7	0.0	0.5	0.3	0.9	0.1	0.5	0.4	0.5	5.0	0.0	1.2	0.0	0.0	1.4
2 Crude materials, except fuels	11	18	6	6	35	28	49	41	37	155	62	20	22	45	7	10	35
%	28.9	8.4	15.4	66.7	6.0	8.2	6.2	4.8	6.1	4.5	6.1	25.0	48.9	13.5	35.0	27.0	16.5
3 Fuels and lubricants						1	1	2	3	9	6						2
%	0.0	0.0	0.0	0.0	0.0	0.3	0.1	0.2	0.5	0.3	0.6	0.0	0.0	0.0	0.0	0.0	0.9
4 Oils, fats and waxes	1	1			5		5	6	1	6							
%	2.6	0.5	0.0	0.0	0.9	0.0	0.6	0.7	0.2	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
5 Chemicals		25	3		82	32	106	166	101	696	156	11	5	26	1	3	1
%	0.0	11.7	7.7	0.0	14.0	9.4	13.5	19.3	16.7	20.4	15.4	13.8	11.1	7.8	5.0	8.1	7.1
6 Manufactured goods classified	8	55	20		249	156	286	238	183	1124	308	13	9	101	2	7	71
by material %	21.1	25.7	51.3	0.0	42.6	45.6	36.3	27.6	30.2	33.0	30.5	16.3	20.0	30.2	10.0	18.9	33.5
7 Machinery and transport goods	4	23	1	2	43	30	152	286	196	726	249	19	5	95	7	8	48
%	10.5	10.7	2.6	22.2	7.4	8.8	19.3	33.2	32.3	21.3	24.6	23.8	11.1	28.4	35.0	21.6	22.6

SITC description	Afghanistan	Bangladesh	Bhutan	Maldives	Nepal	Pakistan*	Sri Lanka	Brazil	Russia	China	South Africa	CARICOM	Central Africa	East and Southern Africa PACIFIC	SADC	West Africa
8 Miscellaneous manufactures	5	56	4		111	62	156	102	77	605	164	10	4	47	2	5	29
%	13.2	26.2	10.3	0.0	19.0	18.1	19.8	11.8	12.7	17.8	16.2	12.5	8.9	14.1	10.0	13.5	13.7
9 Commodities not elsewhere classified								1	1	2	2			2			
%	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.2	0.1	0.2	0.0	0.0	0.6	0.0	0.0	0.0
Total affected tariff lines	38	214	39	9	584	342	788	862	606	3407	1011	80	45	334	20	37	212
% share of affected tariff lines that face zero	2.6	2.8	0.0	0.0	1.5	1.2	1.4	1.0	1.3	0.9	1.0	0.0	0.0	3.9	0.0	2.7	1.4
% share of affected lines in total tariff lines traded	77.6	89.9	90.7	100.0	90.7	89.5	93.4	97.6	96.8	93.7	95.9	98.8	95.7	89.8	80.0	90.2	94.2

Source: COMTRADE, TRAINS, own calculations.

*Pakistan benefited from special treatment under the GSP anti-trafficking arrangement in 2004, values reported are 2006 tariffs.

Calculations at HS 6 digits and aggregated up.

Table II.12. Indian tariffs on EU for positive third country exports to India (2004)

SITC description	Afghanistan	Bangladesh	Bhutan	Maldives	Nepal	Pakistan	Sri Lanka	Brazil	Russia	China	South Africa	CARICOM	Central Africa	East and Southern Africa	PACIFIC	SADC	West Africa
0 Food and live animals	34.2	41.1	40.0	30.0	39.3	40.4	44.2	52.5	33.3	38.3	36.3	56.7	30.0	48.8	76.7	45.0	36.4
1 Beverages and tobacco	182.0	30.0	30.0		104.0	30.0	93.4	30.0	80.7	105.1	72.0	144.0		85.5			80.7
2 Crude materials, except fuels	18.8	18.3	12.1	19.2	17.0	19.4	19.4	14.8	13.5	16.1	12.9	15.7	12.8	15.3	16.5	15.0	16.9
3 Fuels and lubricants						15.0	15.0	13.3	15.0	14.4	14.2						12.5
4 Oils, fats and waxes	30.0	73.3			59.3		73.1	53.6	30.0	57.5	45.0						
5 Chemicals		15.2	15.0		17.7	15.0	15.6	16.8	14.9	15.8	17.4	16.4	15.0	17.9	15.0	15.0	18.6
6 Manufactured goods classified by material	15.0	19.9	15.5		18.5	25.4	20.4	15.8	16.2	19.1	16.2	15.4	15.0	18.3	17.5	15.0	16.3
7 Machinery and transport goods	15.0	18.0	15.0	7.5	16.0	10.8	12.8	14.0	13.2	14.3	13.9	12.6	15.0	13.3	12.9	13.3	14.0
8 Miscellaneous manufactures	15.0	24.2	15.0		24.1	16.1	20.1	13.9	12.9	18.0	14.6	15.0	15.0	18.5	15.0	15.0	14.8
9 Commodities not elsewhere classified								15.0	15.0	15.0	15.0			15.0			
Average	26.7	24.4	18.1	17.8	22.6	23.0	20.6	16.3	14.9	18.0	17.1	22.8	14.3	19.3	22.6	19.0	17.7

Source: COMTRADE, TRAINS, own calculations.

*Pakistan benefited from special treatment under the GSP anti-trafficking arrangement in 2004, values reported are 2006 tariffs.

Calculations at HS 6 digits and aggregated up.

Table II.13. Average tariffs on excluded countries per 'affected' line (2004)

SITC description	Afghanistan	Bangladesh	Bhutan	Maldives	Nepal	Pakistan*	Sri Lanka	Brazil	Russia	China	South Africa	CARICOM	Central Africa	East and Southern Africa	PACIFIC	SADC	West Africa
0 Food and live animals	28.8	39.2	30	30	38.9	36.7	40.9	50.3	35	37.29	35.8	56.67		47.1	100	52.5	37.8
1 Beverages and tobacco	182	30	30		104	30	93.4	30	80.7	105.1	72	144		85.5			80.7
2 Crude materials, except fuels	24.5	29.4	22.5	27.5	25	25.5	26.7	24.4	23.5	23.13	20.9	25.25	21.6	23.1	17.9	26	23.9
3 Fuels and lubricants						30	20	27.5	21.7	22.78	21.7						17.5
4 Oils, fats and waxes	30	35			42		54	55.8	30	53.33							
5 Chemicals		28.6	30		31	28.8	29.2	29.7	28.8	29.8	30.9	30	29	28.8	30	25	29.7
6 Manufactured goods classified by materials	29.4	28	29.5		28.6	28.5	28.9	29.6	29	29.04	29.5	29.23	30	28	27.5	28.6	28.2
7 Machinery and transport goods	26.3	30.2	30	22.5	28.1	24.7	25.3	26.4	25.4	26.54	26.2	24.74	28	25.7	24.3	26.3	26.5
8 Miscellaneous manufactures	30	29.6	28.8		29.6	27.8	28.8	26.6	25.1	28.22	28	27	30	28	27.5	27	26.6
9 Commodities not elsewhere classified								30	30	30	30			30			
Average	31.6	30.6	28.5	26.7	30.4	28.6	29.2	28.6	27.2	28.76	28.6	33.76	25.6	28.2	26.8	29.5	28

Source: COMTRADE, TRAINS, own calculations.

*Pakistan benefited from special treatment under the GSP anti-trafficking arrangement in 2004, values reported are 2006 tariffs.

Calculations at HS 6 digits and aggregated up.

Table II.14. Share of bilateral trade with the EU possibly affected from extension of preferences to India (2004) (in percentages)

SITC description	Afghanistan	Bangladesh	Bhutan	Maldives	Nepal	Pakistan*	Sri Lanka	Brazil	Russia	China	South Africa	CARICOM	Central Africa	East and Southern Africa	PACIFIC	SADC	West Africa
0 Food and live animals	16.91	4.07	1.35	3.43	5.90	36.08	2.74	25.15	0.06	0.38	0.64	0.20	0.00	28.36	0.71	76.17	31.69
1 Beverages and tobacco	0.03	0.50	6.45	0.00	3.41	0.01	0.02	0.02	0.00	0.03	0.00	0.66	0.00	0.71	0.00	0.00	0.00
2 Crude materials, except fuels	22.87	3.73	0.85	95.70	1.35	7.70	9.33	6.05	7.70	2.12	5.88	18.35	94.66	29.88	60.72	12.46	28.04
3 Fuels and lubricants	0.00	0.00	0.00	0.00	0.00	1.79	0.01	0.01	10.16	11.97	2.07	0.00	0.00	0.00	0.00	0.00	0.88
4 Oils, fats and waxes	0.02	0.15	0.00	0.00	4.24	0.00	5.28	1.68	0.00	0.02	0.00	0.00	0.00	0.00	0.00	0.00	0.00
5 Chemicals	0.00	47.89	0.27	0.00	23.94	2.06	2.40	20.18	20.51	16.50	8.92	0.35	1.59	6.85	0.01	0.13	22.55
6 Manufactured goods classified by material	0.09	8.97	67.68	0.00	41.07	16.13	49.89	6.96	54.29	18.29	5.21	14.03	2.84	22.53	0.12	0.20	2.27
7 Machinery and transport goods	0.03	0.95	0.02	0.18	1.62	0.33	15.97	10.19	3.26	38.75	2.75	65.86	0.11	0.80	0.14	1.21	5.54
8 Miscellaneous manufactures	0.02	4.06	3.17	0.00	6.26	1.78	4.44	0.92	1.98	5.56	0.32	0.30	0.02	0.51	0.02	6.18	0.18
9 Commodities not elsewhere classified	0.00	0.00	0.00	0.00	0.00	0.00	0.00	1.46	0.00	0.08	73.77	0.00	0.00	0.69	0.00	0.00	0.00
% share of trade with India	39.96	70.33	79.79	99.31	87.78	65.88	90.08	72.62	97.97	93.70	99.57	99.75	99.21	90.33	61.73	96.34	91.15
% share of total trade	9.16	0.41	72.96	0.27	44.00	0.51	5.52	0.55	0.70	0.76	4.15	0.35	0.41	1.60	1.47	0.22	1.40

Source: COMTRADE, TRAINS, own calculations.

*Pakistan benefited from special treatment under the GSP anti-trafficking arrangement in 2004, values reported are 2006 tariffs.

Calculations at HS 6 digits and aggregated up.

The extent of trade diversion and/or trade re-orientation will also depend on the value of exports from excluded countries to India that will suffer from increased competition. Table II.14 investigates the importance of trade for the affected tariff lines that could suffer from these adverse effects. In so doing, we can provide an upper bound trade value of excluded country exports to India that could be negatively affected by Indian preferences to the EU. Table II.14 shows that the countries that could suffer most from increased competition from the EU to the Indian market will be Bhutan and Nepal. This is to be expected given that they are landlocked and thus have a strong dependence on India as an export market. This effect will, however, depend on the similarity of Bhutanese and Nepalese exports to India to those of the EU. If Bhutan and Nepal mainly use India as an export platform to the world, the competition effects will be small. If, however, Nepal and Bhutan are found to export qualitatively the same type of goods to India as does the EU, the competition effects could be very pronounced.

Table II.14 suggests that, for the BRICS, there is a possibility of a large proportion of exports to India that could be affected by adverse effects, with over 90 per cent of exports of Russia, South Africa and China suffering from increased competition from the EU. However, the Indian market represents a very small share of these countries' total exports which suggests that the global effects will be small. In the case of ACP countries, the same conclusions can be extended; a large proportion of their exports to India will potentially suffer increased competition from the EU, but this represents a small share in total exports. In this grouping, the increased competition faced in the Indian market will be concentrated in agricultural goods.

Overall, the analysis suggests strong competition effects on excluded country access to India in particular industries, but reveals that the Indian market does not tend to represent an important share of total exports (except for Bhutan and Nepal). This suggests that the global effects of increased EU-preferences in the Indian market will be of strong magnitude in affected lines, but of small magnitude in global terms. In all these cases, of course, as the Indian economy grows, the damage from the FTA relative to the situation that would prevail without it will grow, and in these terms the FTA could eventually become significant.

Notes

46 While HS-6 data seem fairly disaggregated, it turns out that they imply rather different results for certain statistics than we get from the 8 or 10-digit data used in the previous section. The reason is that aggregating 10-digit tariffs to 6-digits has the effect of increasing the share of trade apparently subject to positive tariffs.

47 This exercise is somewhat different to that carried out in the previous section in so far as we use compositional tariffs at 6-digits rather than all tariffs. In essence, we only identify the tariff lines that have positive trade values at 6-digit levels that might be affected by the EU–India agreement. In the analysis presented in the previous section, we have made the analysis using either 10 or 8 digits for the European Union and Indian imports respectively.

48 Calculations are carried out at 6-digit level.

49 It will be plain that Table II.10 implies some rather different results from Table II.4A. This is a result of the aggregation of the tariff data from 10 to 6 digits, which has the effect of increasing the share of trade apparently subject to positive tariffs. Suppose that three 10-digit headings combine to form one 6-digit code and that they have tariffs on India of 10%, 0% and 0% and exports from the excluded country of €1, €10 and €20 respectively. In the 10-digit exercise, a positive tariff of 10% applies to €1 of trade, while in the 6-digit exercise the average tariff of 3.33% apparently applies to €31 of trade. Thus in Table II.10 we report Afghanistan as having 16.39 per cent of its exports to the EU in the affected class, whereas in Table II.4A we suggested that 99.1 per cent of its exports to the EU faced 'no change' because both it and India faced zero tariffs in the relevant headings. A further complication is that whereas Table II.4A used data from 2003, Table II.10 used 2004. This means that the share of total exports going to the EU used in Table II.10 differs slightly from that reported in Table II.4A.

50 We note high average tariffs on SITC sector 1 (Beverages and Tobacco). These are largely in tobacco products which face high tariffs in the EU.

Chapter 4

Terms of trade effects

The discussion so far has followed the well-worn track of trying to estimate the way in which the EU–India FTA will affect the volume of trade flows between the partners and other countries and to allocate the latter between trade diversion and trade re-orientation.[51] This last chapter turns to the less frequently studied issues discussed in Part I based on the stream of analysis stemming from Winters (1997) through to Chang and Winters (2002) and Chang and Schiff (2004). It concerns the effect of the FTA on the terms of trade of excluded countries. Recall that while the changes in the terms of trade are driven by the *changes* in trade volumes of the sort we have been analysing so far, their potential effects on the terms of trade are related to the *levels* of trade.

The essence of the analysis of this chapter is that as the FTA diverts demand from excluded to included countries, the prices commanded by the former are likely to decline. The important point for economic welfare, however, is not the volume or value of the lost exports *per se* – which may after all have cost just as much to produce as they earned in revenue – but the fact that, as demand falls, suppliers are driven back down the supply curves (or choose to cut their prices if they have any pricing discretion), so that the prices they charge ***on all their sales*** to the FTA may fall[52]. The loss entailed in this is a function of (a) the decline in price, which we can only speculate about, although the incentive to cut prices is related to the importance of the newly preferred supplier in the overall market and the extent of the preference that they receive, and (b) the level of existing trade, which we know.[53]

To capture these possibilities we present, for each partner, the proportions of 'active' trade headings (the headings in which they actually export to the EU) and of the value of total exports falling into different cells of a matrix cross-classified by the Indian share of the EU market and the size of the tariff that India previously faced. (Recall that we assume that all tariffs are removed by the EU–India agreement immediately.) The further right and lower down one goes in the sub-tables, the greater the terms of trade effect on excluded countries is likely to be: that is, where India is a market leader and where India receives a large improvement in access in the EU, the larger the likely competitive pressure on excluded suppliers. These are tendencies, of course, not precise predictions for each heading; without a great deal more information about market conditions we cannot assert, say, that any heading with a larger Indian share will have greater terms of trade changes than any heading with a smaller one, even if they have equal degrees of preference.

The cross-classification is undertaken at 6-digits and aggregated up to the identified categories. The more intense is the shading in the tables, the greater the scope for adverse effects, *ceteris paribus.* If India does not export a heading to the EU, or if the tariff she faces is zero, we assume that the terms of trade effect will be zero, so we isolate such cases in the

first row and column of each sub-table. Here we are implicitly assuming that trade structures are fixed so that the FTA does not generate imports in trade headings which India previously did not supply at all. This is clearly a major assumption – and especially so for the reverse case of EU exports to India – but is unavoidable at this level of generality. Also in mitigation, it is also likely that for headings in which the EU is entirely excluded from the Indian market, or vice versa, imports from other partners are likely to be small as well. Where FTAs are being examined *ex post*, however, 'new trade' is an important dimension – see Winters (forthcoming) on the Indian-Sri Lankan FTA.

A second assumption is that the data for 2004 give a reasonable representation of India's market share in the year in which the FTA is implemented. For textiles and clothing this may not be true, for as noted above, the MFA still applied in 2004. However, the effect of abolishing the MFA should have been to increase competition in import markets and so, even if we are under-estimating India's share (and we might by over-estimating it since other countries might have made more of the abolition than did India), we may still not be underestimating her market power and hence her ability to determine prices.

Terms of trade effects in the EU market

For India, Table II.15 counts the number of tariff lines that fall into each category identified[54]. As can be seen, the bottom-right value in the table indicates that there is only 1 tariff line in which India has a share of over 25 per cent of the EU market and in which the current tariff faced by India is above 10 per cent.

Table II.15: Indian access to the EU market by market share and tariff faced (2004)

		Tariff lines				Percentage of tariff lines			
		0%	<10%	10–25%	>25%	0%	< 10%	10–25%	> 25%
Tariff differential	0%	722	2413	51	22	13.83%	46.23%	0.98%	0.42%
	<5%	253	710	32	23	4.85%	13.60%	0.61%	0.44%
	5–10%	113	626	34	18	2.16%	11.99%	0.65%	0.34%
	>10%	105	97	0	1	2.01%	1.86%	0.00%	0.02%

Source: Own calculations using COMTRADE and TRAINS.

Note: The left panel presents the quantity of tariff lines affected and the right panel shows the share of left panel tariff lines out of total tariff lines.

Table II.16 indicates the importance of the tariff lines identified above for excluded countries' exports to the EU. This gives us an indication of the possible scope for their suffering adverse terms of trade effects. We reiterate that, in this section, we are considering not the potential for changes in the volume of trade, as we did in Part II Chapters 1–3, but that for changes in the prices at which trade occurs. The latter is likely to be related to the size of the new tariff preference received by Indian exporters – their scope to cut their prices – and the importance of Indian exporters in the EU market – which proxies the extent to which their price cuts would disturb the EU market for other suppliers. The columns on the left identify excluded countries' exports to the EU as a proportion of their total exports to the EU.

Table II.16. Third party exports to the EU cross classified (2004)[55]

	Tariff differential	Share EU India market share in EU 0%	< 10%	10–25%	> 25%	Share World India market share in EU 0%	< 10%	10–25%	> 25%
Afghanistan	0%	43.00	43.85	0.00	0.00	7.86	8.02	0.00	0.00
	< 5%	0.06	2.72	0.00	0.80	0.01	0.50	0.00	0.15
	5–10%	0.05	1.35	7.88	0.06	0.01	0.25	1.44	0.01
	> 10%	0.01	0.21	0.00	0.00	0.00	0.04	0.00	0.00
Bangladesh	0%	0.01	0.99	0.27	0.46	0.01	0.57	0.16	0.27
	< 5%	0.05	2.28	0.01	0.35	0.03	1.33	0.01	0.21
	5–10%	0.00	92.57	1.58	0.35	0.00	53.93	0.92	0.21
	> 10%	0.00	1.06	0.00	0.02	0.00	0.62	0.00	0.01
Bhutan	0%	4.29	77.31	0.05	0.00	0.06	1.16	0.00	0.00
	< 5%	0.00	11.45	0.00	0.00	0.00	0.17	0.00	0.00
	5–10%	0.00	3.45	0.21	0.00	0.00	0.05	0.00	0.00
	> 10%	0.61	2.62	0.00	0.00	0.01	0.04	0.00	0.00
Maldives	0%	0.01	5.18	0.00	0.00	0.00	0.89	0.00	0.00
	< 5%	0.00	0.32	0.00	0.00	0.00	0.05	0.00	0.00
	5–10%	0.00	4.40	0.00	0.00	0.00	0.76	0.00	0.00
	> 10%	0.04	90.04	0.00	0.00	0.01	15.45	0.00	0.00
Nepal	0%	0.04	10.65	0.77	0.15	0.01	1.99	0.14	0.03
	< 5%	0.19	7.21	0.01	0.24	0.04	1.35	0.00	0.05
	5–10%	0.00	23.72	56.14	0.74	0.00	4.43	10.49	0.14
	> 10%	0.01	0.12	0.00	0.00	0.00	0.02	0.00	0.00
Pakistan	0%	0.09	11.20	5.65	0.03	0.03	4.13	2.08	0.01
	< 5%	0.01	7.16	3.40	0.32	0.00	2.64	1.25	0.12
	5–10%	0.24	62.12	4.30	2.90	0.09	22.89	1.59	1.07
	> 10%	0.88	0.71	0.00	1.00	0.32	0.26	0.00	0.37
Sri Lanka	0%	0.09	26.83	8.95	0.40	0.03	9.62	3.21	0.14
	< 5%	0.01	4.66	0.05	0.15	0.00	1.67	0.02	0.05
	5–10%	0.01	54.33	2.20	0.24	0.00	19.48	0.79	0.09
	> 10%	0.00	2.08	0.00	0.00	0.00	0.75	0.00	0.00
Brazil	0%	6.65	64.28	0.81	0.07	1.74	16.85	0.21	0.02
	< 5%	2.19	9.39	0.05	0.04	0.57	2.46	0.01	0.01
	5–10%	1.62	6.07	0.03	0.02	0.42	1.59	0.01	0.00
	> 10%	6.40	2.49	0.00	0.00	1.68	0.65	0.00	0.00
Russia	0%	65.84	26.23	0.53	0.00	32.85	13.09	0.27	0.00
	< 5%	1.45	2.94	0.00	0.00	0.72	1.47	0.00	0.00
	5–10%	0.05	2.50	0.01	0.01	0.03	1.25	0.00	0.00
	> 10%	0.09	0.38	0.00	0.00	0.04	0.19	0.00	0.00

	Tariff differential	Share EU India market share in EU 0%	< 10%	10–25%	> 25%	Share World India market share in EU 0%	< 10%	10–25%	> 25%
China	0%	1.31	64.34	1.21	0.03	0.27	13.02	0.24	0.01
	< 5%	0.66	13.89	0.24	0.03	0.13	2.81	0.05	0.01
	5–10%	0.12	15.25	0.58	0.19	0.02	3.08	0.12	0.04
	> 10%	0.13	2.00	0.00	0.00	0.03	0.40	0.00	0.00
South Africa	0%	10.60	69.14	1.53	0.00	3.87	25.24	0.56	0.00
	< 5%	1.46	5.79	0.45	0.01	0.53	2.12	0.16	0.00
	5–10%	1.25	7.98	0.02	0.01	0.46	2.91	0.01	0.00
	> 10%	0.56	1.16	0.00	0.00	0.20	0.42	0.00	0.00
Caricom	0%	27.44	19.44	0.04	0.01	4.72	3.34	0.01	0.00
	< 5%	1.49	26.19	0.00	0.00	0.26	4.50	0.00	0.00
	5–10%	0.19	5.14	0.01	0.00	0.03	0.88	0.00	0.00
	> 10%	0.08	18.90	0.00	1.06	0.01	3.25	0.00	0.18
Central Africa	0%	47.25	42.73	0.01	0.00	13.15	11.89	0.00	0.00
	< 5%	0.01	1.59	0.02	0.00	0.00	0.44	0.01	0.00
	5–10%	0.47	3.23	0.00	0.00	0.13	0.90	0.00	0.00
	> 10%	0.01	4.67	0.00	0.00	0.00	1.30	0.00	0.00
Eastern and Southern Africa	0%	4.08	21.15	4.64	0.42	1.40	7.25	1.59	0.14
	< 5%	0.56	23.71	0.13	0.10	0.19	8.13	0.05	0.03
	5–10%	0.56	27.72	1.05	0.08	0.19	9.51	0.36	0.03
	> 10%	0.11	15.69	0.00	0.00	0.04	5.38	0.00	0.00
Pacific	0%	20.38	38.10	0.59	0.00	3.52	6.58	0.10	0.00
	< 5%	0.03	34.08	0.00	0.00	0.01	5.89	0.00	0.00
	5–10%	0.01	0.77	0.00	0.00	0.00	0.13	0.00	0.00
	> 10%	0.04	5.99	0.00	0.00	0.01	1.03	0.00	0.00
SADC	0%	19.29	49.20	0.68	0.01	5.87	14.96	0.21	0.00
	< 5%	0.42	3.14	0.09	0.00	0.13	0.95	0.03	0.00
	5–10%	0.17	24.17	0.02	0.00	0.05	7.35	0.01	0.00
	> 10%	2.34	0.47	0.00	0.00	0.71	0.14	0.00	0.00
West Africa	0%	51.33	31.06	0.47	0.04	14.08	8.52	0.13	0.01
	< 5%	0.07	6.98	0.44	0.28	0.02	1.91	0.12	0.08
	5–10%	2.42	2.53	0.02	0.01	0.66	0.69	0.01	0.00
	> 10%	0.11	4.44	0.00	0.00	0.03	1.22	0.00	0.00

SOURCE: Authors' calculations using COMTRADE and TRAINS.

In the right panel we divide exports to the EU by category by the value of their total exports to the world.

What emerges from Table II.16 is that the amount of trade likely to be affected by adverse

terms of trade effects is low. However, some countries fare worse than others, with the worst hit being Nepal, followed at some distance by Afghanistan and Pakistan. Their challenge is that they export more heavily to the EU in products in which India simultaneously has an important market share (>10 per cent) and faces a high tariff (>5 per cent). Nepal is landlocked and exports mainly through India. It already has a co-operation agreement covering its exports and imports from India and so may very well need to be treated specially in an EU–India FTA. The analysis in Table II 16 re-emphasises this need.

For the majority of excluded countries, the potential terms of trade shock looks muted. Many are heavily concentrated in commodities in which India has a positive but small market share (up to 10 per cent) and a positive but small tariff (up to 5 per cent). Within this class there may be cases in which the FTA implies an adverse terms of trade shock of a few per cent, but overall the problems do not look likely to be large.

Terms of trade effects in the Indian market

We now complete the same exercise for EU access to the Indian market. This entails cross-classifying excluded countries' exports to India according to the EU's share of Indian imports and India's tariff. Table II.17 counts EU tariff lines that enter the Indian market according to the identified criteria. As can be seen, when comparing this table to Table II.13, EU goods have a much higher market share in the Indian market than do Indian goods in the EU market. Furthermore, EU goods also face higher tariffs (over 90 per cent of EU tariff lines face tariffs that are above 10 per cent). Thus, in this dimension, the FTA looks likely to have much greater adverse terms of trade effects on excluded countries.[56]

Table II.17. EU access to the Indian market by market share and tariff faced (2004)

		Tariff lines				Percentage of tariff lines			
		0%	<10%	10–25%	>25%	0%	< 10%	10–25%	> 25%
Tariff differential	0%	17	37	30	42	0.33%	0.71%	0.57%	0.80%
	<5%	1	1	0	5	0.02%	0.02%	0.00%	0.10%
	5–10%	27	23	11	17	0.52%	0.44%	0.21%	0.33%
	>10%	873	1,076	789	2,275	16.71%	20.60%	15.10%	43.55%

Source: Own calculations using COMTRADE and TRAINS

The sub-tables in Table II.18 are analogous to those of Table II.16, but with excluded countries' exports to India cross-classified by the EU exports in India and India's tariff. From the tables on the left of the figure we see that the potential for a strong terms of trade effect is relatively high with respect to countries' exports to India: they all have a material share of their exports in the four 'vulnerable' cells in the bottom right and the bulk in the positive share/high tariff cell. However, the right-hand panel shows that, for most countries, since exports to India are a relatively small share of these countries' total exports, the overall effect is not very strong. This does not apply to other SAARC partners, however, which trade heavily in the Indian market. Nepal and Bhutan could suffer from

seriously adverse terms of trade effects, since more than 10 per cent of their total exports lie in the vulnerable categories. The goods concerned are apparel (HS 62) and carpets (HS 57), and toilet and kitchen linen of cotton (HS 63) and fresh fish (HS 3) respectively. Sri Lanka also has significant exposure, mainly via trade re-orientation, since the Sri Lanka-India FTA appears to have stimulated a fair amount of mutual trade – see Winters (forthcoming).

Table II.18. Excluded countries' exports to India cross classified by EU share and Indian tariffs (2004)

		Share EU				Share World			
	Tariff differential	India market share in EU				India market share in EU			
		0%	< 10%	10–25%	> 25%	0%	< 10%	10–25%	> 25%
Afghanistan	0%	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
	< 5%	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
	5–10%	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
	> 10%	37.24	58.30	4.19	0.27	8.50	13.31	0.96	0.06
Bangladesh	0%	0.00	0.01	0.00	0.06	0.00	0.00	0.00	0.00
	< 5%	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
	5–10%	0.03	33.25	0.00	0.00	0.00	0.19	0.00	0.00
	> 10%	27.85	26.42	5.18	7.20	0.16	0.15	0.03	0.04
Bhutan	0%	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
	< 5%	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
	5–10%	0.17	0.21	0.00	0.00	0.15	0.19	0.00	0.00
	> 10%	18.96	69.62	3.02	8.01	17.11	62.81	2.73	7.23
Maldives	0%	0.00	0.01	0.00	0.00	0.00	0.00	0.00	0.00
	< 5%	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
	5–10%	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
	> 10%	0.00	3.86	96.08	0.05	0.00	0.01	0.26	0.00
Nepal	0%	0.06	0.00	0.00	0.08	0.03	0.00	0.00	0.04
	< 5%	0.00	0.00	0.00	0.04	0.00	0.00	0.00	0.02
	5–10%	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
	> 10%	12.01	52.71	18.56	16.53	6.02	26.40	9.30	8.28
Pakistan	0%	0.00	0.02	0.20	0.19	0.00	0.00	0.00	0.00
	< 5%	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
	5–10%	0.00	0.06	0.00	0.00	0.00	0.00	0.00	0.00
	> 10%	34.05	54.73	6.18	4.57	0.26	0.43	0.05	0.04
Sri Lanka	0%	0.00	1.04	0.16	0.05	0.00	0.06	0.01	0.00
	< 5%	0.00	0.00	0.00	0.01	0.00	0.00	0.00	0.00
	5–10%	0.04	0.08	0.15	0.00	0.00	0.01	0.01	0.00
	> 10%	9.68	54.20	23.69	10.91	0.59	3.32	1.45	0.67

Brazil	0%	0.00	0.16	0.05	0.10	0.00	0.00	0.00	0.00
	< 5%	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
	5–10%	7.09	0.42	0.61	0.00	0.05	0.00	0.00	0.00
	> 10%	20.09	54.21	6.83	10.46	0.15	0.41	0.05	0.08
Russia	0%	0.00	0.01	0.09	0.12	0.00	0.00	0.00	0.00
	< 5%	0.00	0.00	0.00	0.08	0.00	0.00	0.00	0.00
	5–10%	0.00	1.86	0.12	0.01	0.00	0.01	0.00	0.00
	> 10%	1.57	57.61	16.52	22.01	0.01	0.41	0.12	0.16
China	0%	0.00	8.82	13.94	1.72	0.00	0.07	0.11	0.01
	< 5%	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
	5–10%	0.82	0.20	0.74	0.01	0.01	0.00	0.01	0.00
	> 10%	3.07	35.47	11.83	23.38	0.02	0.29	0.10	0.19
South Africa	0%	0.00	0.03	0.11	0.05	0.00	0.00	0.00	0.00
	< 5%	0.00	0.00	0.00	0.19	0.00	0.00	0.00	0.01
	5–10%	0.00	3.56	0.07	0.00	0.00	0.15	0.00	0.00
	> 10%	0.27	86.19	3.96	5.57	0.01	3.59	0.16	0.23
Caricom	0%	0.00	0.00	0.00	0.02	0.00	0.00	0.00	0.00
	< 5%	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
	5–10%	0.13	8.55	0.00	0.00	0.00	0.03	0.00	0.00
	> 10%	0.00	79.27	9.80	2.24	0.00	0.28	0.03	0.01
Central Africa	0%	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
	< 5%	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
	5–10%	0.77	54.71	0.00	0.46	0.00	0.23	0.00	0.00
	> 10%	0.02	9.49	30.64	3.92	0.00	0.04	0.13	0.02
Eastern and	0%	0.00	1.78	0.72	0.61	0.00	0.03	0.01	0.01
Southern	< 5%	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Africa	5–10%	0.02	1.54	0.00	0.00	0.00	0.03	0.00	0.00
	> 10%	6.57	72.80	12.07	3.89	0.12	1.29	0.21	0.07
Pacific	0%	0.00	0.00	0.02	0.00	0.00	0.00	0.00	0.00
	< 5%	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
	5–10%	38.05	59.72	0.00	0.00	0.90	1.42	0.00	0.00
	> 10%	0.21	0.83	1.03	0.14	0.00	0.02	0.02	0.00
SADC	0%	0.00	0.01	0.00	0.00	0.00	0.00	0.00	0.00
	< 5%	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
	5–10%	0.00	0.01	0.00	0.01	0.00	0.00	0.00	0.00
	> 10%	3.47	81.31	13.66	1.53	0.01	0.18	0.03	0.00
West Africa	0%	0.00	0.01	0.02	0.02	0.00	0.00	0.00	0.00
	< 5%	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
	5–10%	7.10	13.62	0.02	0.06	0.11	0.21	0.00	0.00
	> 10%	1.55	66.54	9.76	1.31	0.02	1.02	0.15	0.02

SOURCE: Authors' calculations using COMTRADE and TRAINS

Trade competitiveness pressure index

To try to summarise the effects just discussed we now calculate a series of indices to represent the extent to which different excluded countries are vulnerable to FTA-induced terms of trade effects. These have not, to our knowledge, ever been used before, so in the absence of previous experience it is difficult to put an interpretation on their absolute value. They do, however, afford us a useful summary of relativities – i.e. which countries are relatively more vulnerable. The following three statistics have been calculated:

$$A_j = \sum_i x_{ji} * dt_{India.i} * shr^a_{India.i}$$

Where x_{ji} are the exports of country j of product i to the European Union; $dt_{India.i}$ is the change in the European Union tariff on i from India; $shr_{India.i}$ is the share of India in total European Union imports of product i, i.e. the market share of India in the European Union for product i; and a is a parameter summarising the sensitivity of competitive pressure to India's initial share.

$$B_j = \sum_i x_{ji} * dt_{India.i} \qquad C_j = \sum_i x_{ji}$$

B_j is the tariff liberalisation received by India weighted up by country j's exports to the EU, C_j the sum of j's exports to that market. The ratio B_j/C_j is a measure of the liberalisation induced by the FTA in the markets of interest to country j – i.e. tariff reductions matter more where commodity i accounts for a larger share of j's exports. It is similar in form to the analysis of trade diversion given above, and is included here only for information – to present the data on exactly the same basis as we are using for the main index. Our main interest is in the Index of Competitive Pressure, which is

$$ITCP_j = \frac{A_j}{B_j}$$

This expresses the possible terms of trade pressure for country j relative to the maximum that would occur if every advantage granted to India by the FTA was fully passed on to purchasers and fully matched by equal price declines by excluded countries. This is not realistic, for if India were an entirely unimportant supplier, we would expect Indian firms to keep the tariff concessions they receive as higher mark-ups rather than passing them on as lower prices. Thus, the likely effect depends on India's share of the EU's market and the parameter a captures the strength of this effect. One possible bench-mark comes from a model of imperfect competition with varieties differentiated by place of production – as is used in CGE models.

If the price index for a given commodity, k, were given by

$$P_k = \Sigma_j s_{kj} p_{kj}$$

Index j counts across varieties, each from a different country, and if India passed on the whole of its preference in terms of lower prices, the change in the price index for commodity k would be $(s_{k,\,india} * dt_{India})$. If excluded country suppliers felt obliged to match this, they would have to reduce prices by this amount; thus the competitive pressure index with a = 1 weights up their quantities over commodities. Clearly the degree of competitive response is unlikely to be this large – on the parts of both the Indian and other producers

– so in general we would expect the response to require a higher power of the share, i.e. for a > 1. This means that the weights of commodities with smaller Indian shares are reduced in the aggregate. We present below data for a = 1, 2, 3 and 4.

Table II.19. The Competitive Index for excluded countries supplying the EU market in 2004

	Parameter value	1	2	3	4
	B/C	A/B	A/B	A/B	A/B
Afghanistan	0.00048	0.18922	0.07315	0.03367	0.01634
Bangladesh	0.08861	0.05138	0.00562	0.00109	0.00035
Bhutan	0.00510	0.05298	0.00395	0.00030	0.00002
Maldives	0.17234	0.00761	0.00053	0.00006	0.00001
Nepal	0.05130	0.14971	0.05261	0.02305	0.01119
Pakistan	0.06296	0.07695	0.01767	0.00642	0.00283
Sri Lanka	0.05207	0.04387	0.00548	0.00150	0.00075
Brazil	0.02126	0.00723	0.00082	0.00021	0.00009
Russian Federation	0.00529	0.00519	0.00064	0.00017	0.00006
China	0.01998	0.02714	0.00425	0.00140	0.00066
South Africa	0.01087	0.00765	0.00107	0.00042	0.00024
Caribbean	0.07681	0.00949	0.00324	0.00140	0.00063
Central Africa	0.04915	0.00047	0.00007	0.00001	0.00000
Eastern and Southern Africa	0.05003	0.02289	0.00265	0.00055	0.00017
Pacific	0.01667	0.00160	0.00025	0.00013	0.00007
SADC (exc. South Africa)	0.01722	0.00494	0.00054	0.00010	0.00003
West Africa	0.02311	0.00160	0.00065	0.00016	0.00005

Source: Authors' calculations using COMTRADE and TRAINS

In general, we see very small values in Table II.19, although they may conceal a few cases of dramatic impact – as hinted at in the previous tables. It is difficult to know what constitutes a high number for this statistic, but the previous discussion suggests that in this particular case the terms of trade effects are likely to be small. Nonetheless, the ranking across countries is interesting. Exactly as before, it is the countries of the SAARC region that are most vulnerable, but in this case the worst hit would be Afghanistan, Nepal, and Pakistan. These formulae can be easily adjusted to consider European Union access gains in the Indian market. In Table II.20 we present the corresponding statistics.

Table II.20. The Competitive Pressure Index for excluded countries supplying India, 2004

	Parameter value	1	2	3	4
	B/C	A/B	A/B	A/B	A/B
Afghanistan	0.45	0.0071	0.0013	0.0007	0.0005
Bangladesh	0.16	0.0421	0.0151	0.0077	0.0049
Bhutan	0.20	0.0500	0.0094	0.0039	0.0023
Maldives	0.18	0.3109	0.1174	0.0500	0.0237
Nepal	0.24	0.0705	0.0202	0.0085	0.0043
Pakistan	0.30	0.0263	0.0050	0.0016	0.0007
Sri Lanka	0.24	0.0468	0.0136	0.0056	0.0029
Brazil	0.34	0.0416	0.0162	0.0076	0.0039
Russian Federation	0.16	0.1624	0.0482	0.0201	0.0102
China	0.12	0.168	0.0613	0.0284	0.0152
South Africa	0.16	0.0552	0.0163	0.0072	0.0037
Caribbean	0.12	0.2075	0.1077	0.0684	0.0498
Central Africa	0.10	0.2108	0.0828	0.0393	0.0220
East and Southern Africa	0.21	0.0953	0.0302	0.0117	0.0050
Pacific	0.14	0.2002	0.0448	0.0103	0.0025
SADC (exc South Africa)	0.28	0.0492	0.0226	0.0127	0.0080
West Africa	0.19	0.0565	0.0173	0.0062	0.0025

In this case, we see bigger potential effects than in Table II.19, which can be explained by two factors. First, the size of the absolute change in the tariff is bigger since the Indian MFN tariff is, on average, substantially higher than the tariff that India faces on the European Union market. Second, the market shares of the European Union in the Indian market are higher than the market shares of India in the EU market. The relative significance for excluded countries is also different, with the largest effects apparently falling on the Caribbean, Central Africa, the Maldives and China. For these countries, a significant degree of competitive pressure may be felt in the Indian market with the result that export earnings may be curtailed to a material degree. Part of the apparent effect, however, might be an artefact of the HS classification – such that the EU and Central Africa supply the same 6-digit headings to India, but essentially in non-competing forms. In this case, the index over-estimates the effects.

The importance of terms of trade effects has been argued by Winters (1997) and subsequent literature and proven in a couple of cases. We cannot from this exercise assert that they will be very large but they clearly are an area that requires some attention in future work. As we noted above, because price changes apply to all exports of a commodity, not just the margin that is diverted or re-oriented, they have much greater welfare leverage than the latter.

Notes

51 The data are measured in money terms, but since no attention is paid to changes in prices, changes in value equal changes in volume.

52 Indeed a very large FTA may affect the prices of tradable goods throughout the world, but we can ignore that possibility for EU–India.

53 Whether existing suppliers previously faced the same, higher or lower tariffs as the preferred supplier is, at most, a second-order issue.

54 This exercise is not directly comparable to that of the previous section as the aggregation methodology used is different. Given that this analysis is carried out at 6 digit and that the previous at 10 digits, the values reported within this section will bias downwards from those from the previous section.

55 Data for Pakistan refer to 2006, because Pakistan had deeper preferences in 2004 than currently.

56 It is important to note that 98 tariff lines at the HS 6 digit level show the EU holding a 100% market share in the Indian market. For these tariff lines the terms of trade effects will be null because no-one else exports them to India.

Part II References

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Part III

Services

The services sector is extremely important for the EU and India. Both the EU and India are predominantly service economies with more than 70 per cent and 50 per cent of their respective GDPs emanating from services. Any FTA agreement between the two that excludes services would *ipso facto* exclude the most important sectors for both partners. Moreover, there are significant barriers to services trade between the two, so that substantial coverage of services *à la* GATS Article V could help to deliver improved access to both markets and more rapid liberalisation of India's services than can be accomplished unilaterally. Liberalising services offers direct benefits akin to those found in goods sectors, but in addition, recent research has suggested pervasive systemic benefits via the positive impact of services liberalisation on manufacturing productivity in both the Czech Republic and India (Arnold et al., 2006, 2007). Thus the benefits for both the EU and India from services liberalisation will almost certainly be larger benefits than those identified for goods trade liberalisation. And just as for 'regular' goods agreements, a services agreement between the EU and India is likely to have impacts on the excluded countries, and this is the subject of discussion in this chapter.

Chapter 1

The importance of services in a potential EU–India FTA

Services contribute more than 70 per cent of the EU's GDP and two-thirds of its total employment. For India, the sector accounts for half of India's GDP and its importance as an employer has been growing over time, rising from 20 per cent of total employment in 1995 to 32 per cent in 2003. The same holds true of trade in services, which has also witnessed rapid growth in both economies. Services trade accounts for a fifth of all trade for the EU while for India this share is even higher. Table III.1 summarises these data. It demonstrates how important services are from the perspective of any FTA between the EU and India.

Table III.1. Summary data on the significance of services

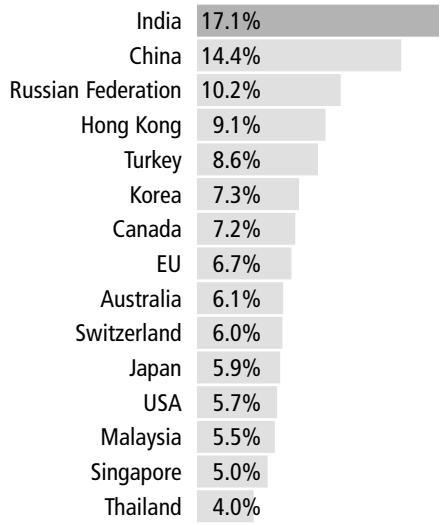
Indicator	EU (1995)	EU (2003)	India (1993)	India (2003)
Agriculture, value added (% of GDP)	2.9	1.9	28.2	20.9
Industry, value added (% of GDP)	29.2	26.4	28.1	26.2
Services, value added (% of GDP)	67.9	71.7	43.6	52.9
Employment in agriculture, (% of total employment)	6.3	4.2	66.7	55.7
Employment in industry, (% of total employment)	32.2	28.7	12.9	12.2
Employment in services, (% of total employment)	61.2	66.8	20.3	32.1
Services exports (% of total exports)	20.5	21.8	17.8	28.3
Services imports (% of total imports)	21.8	21.8	21.3	27.4

Source: World Bank, WDI online

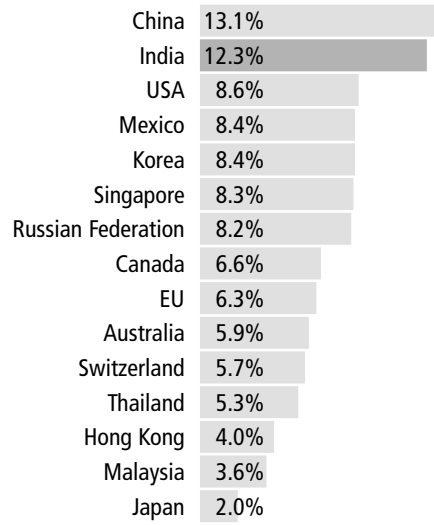
Looking at services trade more closely, India experienced the fastest growth of services exports amongst the top 15 services exporters in 2003 over the period 1993–2003, with this growth exceeding 17 per cent per annum (see Figure III.1 below). This growth rate is more than two-and-a-half times greater than the growth of EU services exports over the same time period, and is significantly higher than that of the Quad (US, EU, Canada and Japan), China and all major South East Asian economies. The picture is similar for services imports with the exception that China exhibited the fastest growth rate of services imports amongst the top 15 services exporters in 2003, with India in second place. Again, over the last decade, India's services imports have gown almost twice as fast as those of the EU and faster than those of the Quad and all major South East Asian economies. (Gasiorek et al., 2007)

Figure III.1. Top 15 service exporters and importers in 2003

India's service exports have grown fastest over the last decade amongst the top 15 service exporters in 2003



India has the second fastest growing services imports over the last decade amongst the top 15 service importers in 2003



Source: Gasiorek et al. (2007)

Considering next the composition of services trade in these two economies, we find that India's services exports to have changed dramatically over the last decade, both in terms of value (a huge increase of 708 per cent from US$9.4 to US$76.2 billion) and structure – see Table III.2 below.

Table III.2. Composition of India's service exports 1997/8, 2006/7

Category (figures in US$ million)	1997–8	2006–7	Growth rate	% share	
Travel	2,914	9,123	213.1%	31%	12%
Transportation	1,836	8,050	338.5%	19%	11%
Insurance	240	1,202	400.8%	3%	2%
Government services	276	250	–9.4%	3%	0%
Communication	171	2,099	1,127.5%	2%	3%
Construction	101	332	228.7%	1%	0%
Financial	296	2,913	884.1%	3%	4%
Software	1,760	31,300	1,678.4%	19%	41%
News agency	156	334	114.1%	2%	0%
Royalties, copyright & licence fees	21	97	361.9%	0%	0%
Management	549	7,346	1,238.1%	6%	10%
OBS	0	12,390		0%	16%
Other services	1,109	745	–32.8%	12%	1%
Total	9,429	76,181	707.9%	100%	100%

Source: Reserve Bank of India Bulletin 2008; own calculations

The most significant change in export structure has occurred in the share of software services – up from 19 per cent in 1997/8 to 41 per cent in 2006/7. Travel and other services have witnessed the other major changes, wherein shares have come down from 30 and 12 per cent in 1997/8 to 12 and 1 per cent, respectively, in 2006/7[57]. On the whole, five sub-sectors comprise the majority of services exports in India – software, travel, transportation, management and other business services (OBS[58]). These made up more than 75 per cent of all services exports in 1997/8, going up to 90 per cent in 2006/7. In terms of growth rates, software, management and communication services have grown more than 10 times during this period.

Changes in EU-15 services exports, on the other hand, have not been comparable to those of India. In terms of value, services exports increased by 97.5 per cent from US$560.8 to US$1107.6 billion, and the structure has not changed by much (see Table III.3 below). Travel, transportation and other business services accounted for 77.5 per cent of all EU-15 services exports in 1996, and 71.6 per cent in 2005. The other sub-sectors make up for the remaining quarter of all EU-15 services exports, and within these, communication, financial and computer-related services have shown appreciable growth rates.

Table III.3. Composition of EU-15 service exports 1996, 2005

Category (figures in US$ million)	1997–8	2006–7	Growth rate	% share	
Transportation	134.4	238.6	77.5%	24%	21.5%
Travel	171.2	265.7	55.2%	30.5%	24%
Communication	9.1	28	209.2%	1.6%	2.5%
Construction	22.5	23.9	6.7%	4%	2.2%
Insurance	14.4	23.8	65.5%	2.6%	2.1%
Financial	28.5	93.2	227.1%	5.1%	8.4%
Computer-related	9	58.1	544.2%	1.6%	5.2%
Royalties and licence fees	18	46.3	156.5%	3.2%	4.2%
OBS	128.8	289.6	124.8%	23%	26.1%
Personal etc.	5.6	11.5	104.5%	1%	1%
Govt	15.2	20.5	35%	2.7%	1.9%
Services not allocated	4.1	8.5	109.2%	0.7%	0.8%
Total	560.8	1107.6	97.5%	100%	100.9%

Source: OECD Stats Online; own calculations.

While this discussion gives us an idea of the importance of the services sector for the EU and India, a more interesting exercise for the purposes of this chapter is to ask how globally competitive the two economies are in the export of these various services. To do this, we calculate indices of Revealed Comparative Advantage (RCA) for various services sub-sectors within services overall. Given that disaggregated data for services are available only for a few categories at the global level, we calculate the RCA with respect to the total for the OECD countries and India over the last decade[59].

The RCA indices reported in Table III.4 and Table III.5 below indicate that, as expected, India has a massive comparative advantage in the export of IT services as well as a significant one in exporting communication services, the latter primarily comprising telecoms exports. Both these sub-sectors are largely driven by private enterprise operating on relatively competitive markets. They are also amongst the most-liberalised sectors in the Indian economy in terms of market access to foreign investment. The interesting difference, however, emanates from the extent of state intervention, government policy and regulation in these services. Indian IT is said to have flourished primarily on account of the

Table III.4. EU's RCA Index in Services vis-à-vis (the OECD+India)

Category	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Transportation	1.0	1.1	1.1	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Travel	1.0	1.0	1.0	1.0	1.0	0.9	1.0	1.0	0.9	0.9
Communication	0.9	0.9	0.9	1	1.2	1.2	1.1	1.1	1.2	1.2
Construction	1.2	1.1	1.2	1.2	1.3	1.3	1.2	1.2	1.2	1.2
Insurance	1.2	1.2	1.0	1.2	1.1	1.2	1.2	1.2	1.1	1.1
Financial	1.2	1.2	1.1	1.2	1.3	1.2	1.0	1.0	1.0	1.0
IT	1.2	1.1	1.2	1.3	1.3	1.3	1.3	1.3	1.3	1.3
Royalties	0.6	0.6	0.5	0.5	0.5	0.5	0.5	0.6	0.6	0.6
OBS	1.2	1.1	1.2	1.2	1.2	1.2	1.1	1.1	1.1	1.1
Personal etc.	0.8	0.7	0.6	0.6	0.6	0.6	0.6	0.7	0.7	0.7
Govt	0.7	0.6	0.6	0.6	0.6	0.6	0.8	0.8	0.8	0.7

Source: OECD Statistical Indicators; own calculations.

Table III.5. India's RCA Index in Services vis-à-vis (the OECD+India)

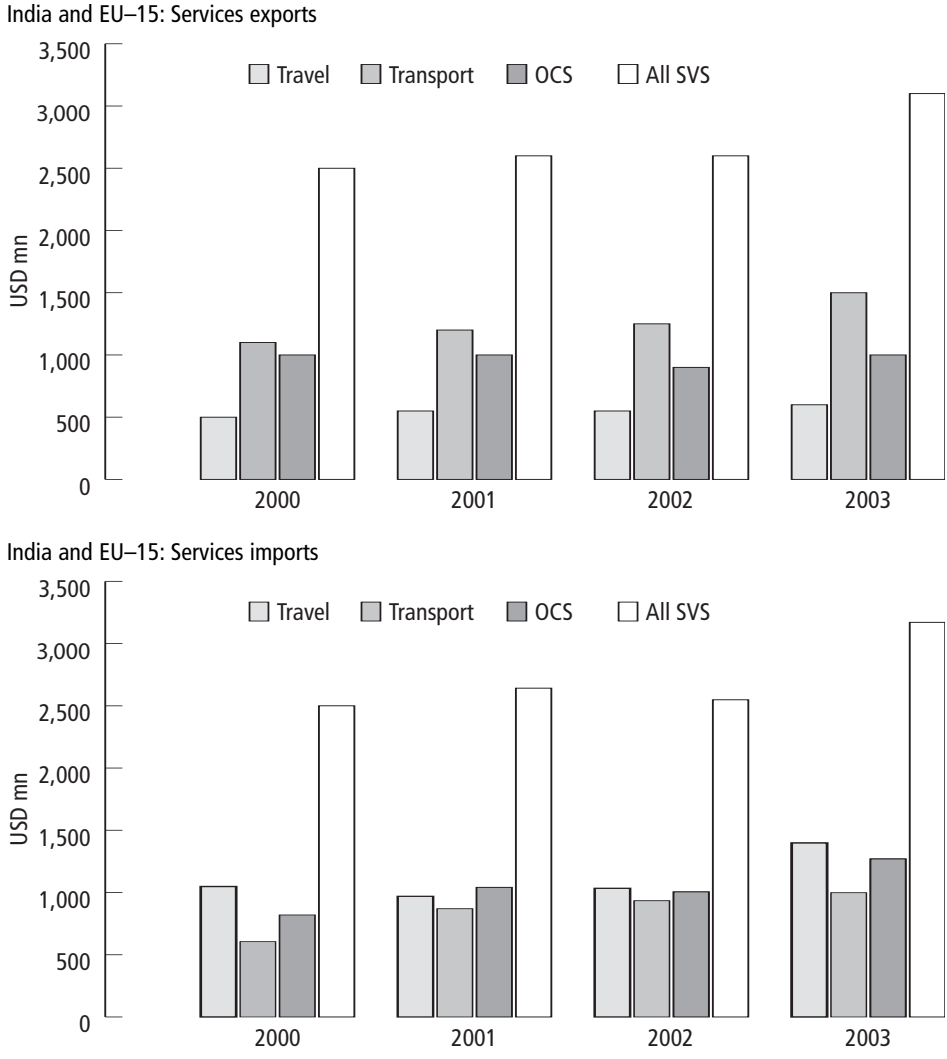
Category	1997	1998	1999	2000	2001	2002	2003	2004	2005
Transportation	0.9	0.7	0.5	0.6	0.6	0.6	0.6	0.5	0.5
Travel	1.0	0.7	0.6	0.7	0.6	0.6	0.7	0.6	0.5
Communication	1.0	2.2	3.3	3.5	2.0	1.8	1.7	1.5	1.3
Construction	0.3	0.4	1.0	1.7	0.4	0.5	0.9	0.6	0.2
Insurance	1.3	0.9	0.7	0.9	0.8	0.6	0.5	0.7	0.8
Financial	0.7	0.4	0.4	0.4	0.3	0.5	0.2	0.2	0.3
IT	10.0	9.1	8.3	11.7	11.0	11.0	10.0	8.2	8.2
Royalties	0.0	0.0	0.1	0.1	0.0	0.0	0.0	0.0	0.1
OBS	0.4	0.3	0.3	0.1	0.1	0.2	0.2	0.6	0.7
Personal etc.	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.2	0.2
Govt	0.8	1.3	1.2	1.4	1.1	0.5	0.3	0.3	0.2

Source: Reserve Bank of India Bulletin 2008, OECD Statistics Online; own calculations.

sector being 'forgotten' by Indian policy makers and continues to operate without a regulator even now[60]. On the other hand, India has always had a National Telecom Policy especially in the aftermath of the New Industrial Policy, 1992 and this sector also has an independent regulator in the form of the Telecom Regulatory Authority of India (TRAI). The EU, on the other hand, has an RCA in communication, construction, financial, computer-related (CRS) and other business services (OBS).

In terms of EU–India bilateral services trade, unfortunately only very crude data are available: they distinguish only travel, transportation and other commercial services ('OCS') and, until 2002, the EU data comprise only the 15 Member states. They are shown in Figure III.2. The first chart depicts India's services exports to the EU and the second India's imports from the EU.

Figure III.2. EU–India bilateral trade in services



Source: Gasiorek et al. (2007)

The share of other commercial services (OCS) in exports and imports is roughly the same and increasing slightly overtime. India exports more transport than travel services to the EU and these exports have been going up, while the situation is exactly the opposite in terms of India's imports from the EU. As noted above, before 2003, the EU data are based on 15 Member states, but when the 10 accession countries are added in for 2003, it makes little difference: India's services exports to the ten new members are only $17 million and imports from them only $25 million.

Putting things in perspective, India's bilateral services trade with the EU both ways is approximately €4.7 billion, which accounts for a fourth of India's global services trade but a mere 1 per cent in the case of the EU. Thus, as for goods, the EU is much more important in India's services trade than vice-versa though India's bilateral services trade with the EU is more important in terms of its relative importance to each trading partner than bilateral goods trade (by way of comparison, India's bilateral goods trade with the EU both ways makes up 18% of India's total goods trade with the rest of the world, but only 0.6% of the EU's total goods trade with the rest of the world).

Notes

57 A major reason for the big change in the contribution of other services exports to the total is their coverage – with a more detailed breakdown of services exports available since 2004–05. This category largely comprises unclassified services, while in the preceding period they also included advertising, rentals, office maintenance, prizes, exhibitions and the like. The latter are now clubbed together under OBS.

58 The RBI Bulletin provides a more detailed breakdown of services exports since 2004–05 compared to the preceding period. The table therefore reports no value for OBS in 1997–98. OBS is a broad category that includes merchanting, trade-related, operational leasing, legal, accounting and auditing, advertising, research and development, architecture and engineering, agricultural mining, maintenance of offices abroad, environmental, personal, cultural & recreational services and refund and rebates. The two major services categories within these are architecture and engineering and maintenance of offices abroad which accounted for 8% and 3%, respectively, of total services exports in 2006/7.

59 The RCA index for a given sector is calculated here by taking the share of a particular sector's exports in India's total exports of services, and dividing this by the ratio of OECD and India's exports in this sector to the total services exports of the OECD and India. An RCA index with value greater than unity indicates a comparative advantage in the sector, while a value less than unity indicates a comparative disadvantage. In this analysis, we need to use the OCED and India as a comparator instead of the rest of the world because disaggregated breakdown of services exports is not available for the rest of the world as for the OECD and India. Thus, the OECD and India is the biggest sample for a comparator that we can have. In any case, the combined services exports of the OECD and India made up more than 75% of global services exports in the last decade.

60 For instance, see Joseph, K.J. and Harilal, K.N. (2001), Joseph, K.J. (2002).

Chapter 2

Barriers to services trade between EU and India and areas of interest in a possible FTA[61]

Although services trade is an important trading sector for the EU and India and bilateral trade between them is relatively strong, there are significant barriers to services trade between the two. Hence an FTA offering substantial coverage of services *à la* GATS Article V could help deliver significant improvements in access to both markets. Our judgement, given the political economy of reforms in India (for instance, see World Bank, 2004), is that it would also allow a more rapid liberalisation of India's services than can be accomplished unilaterally.

Imports of services to India suffer from a range of horizontal barriers such as archaic laws, multiplicity of rules and regulations, inconsistent practices across states and multiplicity of contact points at different levels of bureaucracy, regulatory gaps, public sector bias, and limits on foreign investment and ownership. In general, India's services suffer from simultaneously excessive and inadequate regulation. Many explicit and implicit restrictions – tax incentives, labour laws, for instance – favour small scale units and discriminate against larger firms. Weaknesses in the institutional and regulatory regimes have resulted in disparities in the quality of services and the abilities of professionals. Legitimate universal access goals are pursued not based on the most efficient means but through elaborate restrictions involving efficiency losses without any commensurate gain in equity and access. These policies result in domestic firms that are sub-optimal in size, operate in a weakened regulatory environment, and are burdened with the legacy of pursuing equity goals (For instance, see World Bank, 2004).

In addition to these horizontal problems, Table III.6 below provides a list of sector-specific policy barriers in Indian services.

Considering the recent history of EU–India bilateral trade relations in services, the EU has raised specific market access/national treatment issues and regulatory impediments with India in the case of satellite services (lack of national treatment), telecom (lack of national treatment and burdensome domestic regulation), private security agencies (limits on FDI), courier (proposed legislation on taxation) and air transport services (tax on business/first class tickets for passengers embarking in India). These would seem likely to be key EU demands in an FTA. In terms of specific sector interests, Brussels as well as EU Member state delegations in New Delhi point to key strategic interests in the Indian market in banking, finance and insurance; retail; accountancy; legal; telecom and maritime services. Sectors like IT and telecom are already significantly liberalised in India while

Table III.6. India's autonomous policy on services

Service sector	Issues
Accountancy	FDI not allowed; FSP not allowed to undertake statutory audit of companies. Only partnership firms allowed with number of partners limited to 20.
Architecture	No cap on FDI. Foreign architects need to be registered by the Council of Architecture as individuals. Appointment of foreign architects as consultants to Indian architects subject to case-by-case approval by GoI.
Legal	FDI not allowed. International law firms not allowed presence. Indian advocates cannot enter into profit-sharing arrangements with non-Indian advocates.
Computer-related or Software Services	No cap on FDI. No explicit barriers on commercial presence of foreign firms. Intellectual property laws are not effectively enforced. Tax structure discourages movement along the value chain.
Management and Consultancy	No cap on FDI. Foreign firms must be incorporated in India.
Postal	FDI not allowed. Price preferences to state postal operators. No functional demarcation between regulator and service provider. Imprecise definition of USO.
Courier	No cap on FDI but subject to FIPB approval.
Telecommunications	Fully owned foreign firms allowed in some segments, though voice telephone services continue to have 49 per cent FDI limit. Policy uncertainty on tariff, inter-connect regimes, USOs remain.
Audio-visual Services	No cap on FDI in motion picture but FDI not allowed in radio and television services. Up-linking restrictions.
Construction and Related Engineering	No cap on FDI. Price preference to PSUs, as well as a large number of barriers that are external to the sector: land ceiling; unclear land titles; minimum area restrictions; minimum capitalisation norm; restriction on repatriation.
Distribution	No cap on non-retail segments and 51 per cent limit on FDI in single brand product retail. Lack of clear responsibilities within the government. Large unorganised sector with low tax compliance. Land market distortions.
Education	FDI permitted without cap through the automatic route.
Environmental	FDI permitted without cap through the automatic route.
Financial services (Insurance)	Foreign equity limit of 26 per cent in most segments. Minimum capitalisation norms; Funds of policy-holders to be retained within the country. Compulsory exposure to rural and social sectors and backward classes.
Financial Services (Banking)	Private domestic equity limited to 49 per cent and foreign equity limited to 74 per cent with 10 per cent voting rights. FDI and portfolio investment in nationalised banks subject to overall statutory limits of 20 per cent. Mandatory priority sector lending and rural branch requirements for domestic banks.
Health and Social Services	No cap on FDI. Movement of FSP subject to registration by the Medical/ Dental/Nursing Council of India. FSP cannot provide services for profit. Responsibilities divided between the Centre and states. Absence of a standardised accreditation system.
Tourism	No cap on FDI. Land market distortions.
Recreational, Cultural and Sporting	FDI is permitted in entertainment services (including theatre, live bands and cultural services), libraries, archives and museums. FDI is restricted to 26 per cent through the Government route in print media. FDI is not allowed in News Agency Services. Lottery, betting and gambling is not allowed.
Transport	100 per cent FDI in maritime and road transport but significant restrictions in air and rail transport. Restrictions on inter-state movement of goods. Overlapping responsibilities and coordination issues between government departments (e.g. multi-modal transport).

Source: World Bank (2004); India's FDI Policy (2006); Gasiorek et al. (2007).

others such as construction, health, banking and insurance, education and courier are moderately liberalised. Legal, accountancy, postal and distribution services, on the other hand, are completely closed at present. We presume, however, that the EU would still have objectives in all of them – to consolidate market access in India in IT and telecom services; to significantly improve market access in the moderately liberalised services; and to open up the closed sectors.

The important issues for India are market access for cross-border services (Mode 1[62]) and service professionals (Mode 4 both contractual service providers and service professionals related to Mode 3) and increasingly foreign investment in services abroad (Mode 3). The Indian Ministry of Commerce and Industry maintains that the focus sub-sectors are likely to include computer and related services, financial services and energy services. In Mode 1, India would be looking at increasing the coverage of sub-sectors to research and development, dental and health related sectors and telephone-based services. In Mode 3, issues for negotiation relate to the need for huge minimum capital requirements imposed by the EU, residency requirements, restrictions on legal entity and the absence of national treatment. In Mode 4, India would like to press for the mutual recognition of qualifications to make effective market access possible. Other issues relate to the avoidance of double taxation on social security benefits of Indian services professionals abroad; visa issues and labour market and economic need tests for Indian services providers abroad; and the fact that EU domestic regulation is more burdensome than necessary. In addition to specific modal interests, general issues of priority for India are transparency in EU policies and their implementation and the need for harmonisation of EU policies across Member States. As an illustration from the financial services sector, India will argue that banking sector licences granted by any one EU Member be acceptable across the EU as the need to apply for separate licences in each EU Member state has been pointed to as one of the cumbersome elements of trade in banking services with the EU by Indian government officials.

From India's perspective, it may be easier to negotiate provisions on Modes 1 and 3 into a possible EU–India FTA on services and also examine regulatory issues vis-à-vis Mode 4. It would, however, be more difficult to negotiate mutual recognition agreements across services between these two trading partners. From a European perspective, it may be much easier to consolidate market access in India's liberal sectors and increase access in the moderately liberalised ones. Opening up completely closed sectors would, however, appear to be the most difficult from a negotiating standpoint as far as a potential services agreement between the EU and India is concerned.

Notes

61 Recall from Part I that the information in this section is based on detailed discussions with officials, summarised in Gasiorek et al. (2007) and a number of recent press reports.

62 The GATS classifies four 'modes' of services delivery (these are the different ways in which services can be traded across borders): **Mode One**, which is the cross-border supply of services. An illustration of this is business process outsourcing units in India doing online medical transcriptions. **Mode Two** is consumption of services abroad, e.g. Indian tourists going to the

EU. **Mode Three** is commercial presence, such as Deutsche Bank setting up operations in Mumbai. Finally, **Mode Four** is the movement of natural persons across borders to deliver services, such as Indian software workers delivering and testing a system in the UK.

Chapter 3

The coverage of services in FTA

Despite the evidence of barriers and frictions to many dimensions of services trade there is still a question of whether the parties to an EU–India FTA could actually bring themselves to sign a liberalising agreement. The restrictions to trade may have resulted from pressure from interest groups whose interests they promote, but, even if they are the result of historical accident, their very existence can create interest groups designed to maintain them. Thus one must not underestimate the political challenges of tackling service barriers, as, indeed, the EU has discovered in the pursuit of the Single Market.

Hoekman and Sauvé (1994) discuss the lack of evidence that regional integration agreements (RIAs) – especially those outside the EU – go significantly beyond what was negotiated in the GATS in the early 1990s. 'Roy, Marchetti and Lim (2006) come to the same conclusion as far as the substance of the disciplines (rules) that are included in more recent vintage agreements' (Hoekman, 2006). However, Roy et al. do note that recent RIAs covering services and reported to the WTO since 2000 tend to have a sectoral coverage that greatly exceeds their commitments made in the GATS, their existing GATS commitments and the offers that they made during the Doha Round. (They also find that RIAs involving the US have the most comprehensive coverage and deepest levels of commitments in services.) On the other hand, the resistance inside the EU to fully liberalising intra-EU services trade has also permeated the agreements that it has signed with other trading partners. Of the 20 EU RIAs notified to the WTO, only seven have any form of services coverage and only two of these include a non-European trading partner – Chile and Mexico. Interestingly, none of the Euro-Med or the European Partnership Agreements has any services coverage, which points to the challenge of including services in a possible EU–India FTA. Interestingly, it continues to be the case that most services policy reforms tend to be implemented unilaterally – the average level of Mode 3 market access granted by India unilaterally across sectors is close to 70 per cent, much higher than the 10 per cent in its initial GATS commitments and the 44.8 per cent in its Revised Conditional Offers during the Doha Round negotiations (Gasiorek, et al., 2007). In view of all this, it is important to be realistic about what a EU–India FTA will achieve in the services dimension; despite the interest and the need for deep commitments on both sides, not much may materialise. If this is so, its likely impact on excluded countries is very small.

Chapter 4

The welfare effects of preferential services liberalisation

Having discussed the significance of services for the EU and India, the barriers to trade that exist between them and possible areas of coverage in an EU–India FTA, we now ask whether such liberalisations would be preferential or MFN. The principle of an FTA is discrimination – the preferential liberalisation of trade – but *de facto* it may be difficult, if not impossible, to implement the opening up of some sectors on a preferential basis. While market access and national treatment restrictions may be relaxed on a preferential basis, the removal/reduction of most regulatory barriers has more or less to be on an MFN basis. As an example, the number of partners in Indian accountancy firms is restricted to 20. If this were to be relaxed, it would be extremely difficult to limit this to preferential suppliers. Similarly, improved regulation of banks will apply to all, not just EU and Indian, banks. In such cases, *de jure* preferential access becomes *de facto* MFN access.

One caveat to the *de facto* multilateralisation of concessions is to note that even if all regulations eventually apply to all suppliers, there may be first-mover advantages for the preferred partner in the form of incumbency advantages which operate to the detriment of those from excluded countries. Preferential access to a services supplier could initially be in terms of market access, national treatment and regulatory requirements. These then translate into significant privileges in the domestic market once the foreign supplier has established presence. Think of a retail chain opening an outlet as part of a preferential agreement in a hitherto closed market. Such preferential market access could allow the incumbent significant advantage in terms of domestic clients and resources – access to land, labour, capital, entrepreneurship – and knowledge and use of the supply chain. These may be sufficient to give it a competitive advantage even if it is inferior to more competitive suppliers from the excluded countries. Then such incumbency advantages would have durable adverse welfare consequences relative to a more even-handed liberalisation, and the country could be stuck permanently with weaker providers even when it subsequently liberalises on an MFN basis. Such incumbency-advantages are likely to be particularly important in services with network externalities[63].

On the demand side, once a supplier has been granted preferential access, it may also be able to develop a clientele through advertising and promotional campaigns that pre-empt demand. The more imperfect the consumers' information and the more important the costs of switching suppliers, the greater would be this 'clientele effect.' For example, consumers are often reluctant to switch banks and telecommunications suppliers even when new entrants offer better terms. Such incumbency effects may be stronger in services with network externalities, like telecommunications, where new entrants' technical standards

must be the same as those of the incumbent. On the supply side, the incumbent may succeed in assuring itself of the services of the most capable franchisees and other stages in the supply chain by selecting them initially and imposing exclusivity on them.

Each of these forms of 'capital accumulation' thus enhances the first-mover advantages for a preferential supplier and, once established, allows such an incumbent to restrict or prevent competition. The importance of sunk costs and the consequent incumbency advantages imply that sequential entry can produce very different results from simultaneous entry. If entry is costly, then the incumbent may be able to completely deter entry so that the outcome is a much more concentrated market structure. Moreover, the first-mover advantage conferred on an inferior supplier may be used by it to establish a position of market dominance. Once again, though, the durability of such a position would depend on the importance of sunk costs relative to differences in costs and quality[64].

Notes

63 As Fink and Mattoo (2002) discuss, in a way these incumbency advantages are in the nature of sunk costs of investment and, as shown by Tirole (1988), these matter because of their commitment value and their use as a strategic signalling mechanism by those who are allowed to enter the market first. A firm that establishes a telecommunications or transport network today, for instance, signals that it will be around tomorrow if it cannot easily resell the equipment. Of course, the commitment value would depend on the rate of capital depreciation and would also be specific to the firm/industry. Thus, if some suppliers are allowed preferential access, such incumbents may accumulate enough capital to limit entry of other firms.

64 'Two qualifications to this argument based on sunk costs are important. First, entry by the more efficient firm could take place through acquisition circumventing some of the problems of first-mover advantage. But this would require no asymmetry of information about the value of assets and no direct costs of transferring assets. Secondly, in certain services sectors, firms could learn by doing: the experience acquired by the established banks during the previous period reduces their current costs, enhancing their competitiveness and discourages others from entering. This form of entry deterrence may well promote welfare.' (Fink and Mattoo, 2002)

Chapter 5

Specific case studies from EU–India

To assess the impact of a possible EU–India services agreement on excluded low-income developing countries, one would also have to examine the competition that India faces from such countries in sectors of its strategic interests with the EU, exactly as we did above for the goods markets. It is important to note here that services are a more skill-intensive sector compared to agriculture and industry and the nature of any competition that India faces from other low-income developing countries would be governed by the ability of such countries to compete with India's relatively more-skilled and cheap English-speaking work force. The services sector in India has also been witness to rapid growth, especially since the 1990s, which has now led to India becoming an 'outlier' in terms of its services sector performance in the years since the turn of this century (Shingal, forthcoming). As noted above, services now contribute more than half of the country's GDP, which is higher than the share for countries at a comparable level of per capita income as India. Amongst the top 20 services exporters in 2003, India had the fastest growth of services exports over 1994–2003 and services trade now accounts for a quarter of the country's total trade.

Against this background, as things stand, with the possible exception of construction workers and maybe nurses, other low-income developing countries would hardly be a threat to Indian presence in services in the EU especially in sectors like IT, health, banking and financial services. Moreover, while Indian IT services and medical professionals are globally recognised, it will be some time before Indian banking services, for instance, can win the confidence of European clients. Even in the case of construction workers and nurses, since trade here pertains to the movement of relatively less-skilled labour, which is a politically sensitive issue, India itself is unlikely to get much from the EU in such services in a possible agreement. To that extent, the impact of a possible EU–India services agreement on excluded low-income developing countries would be limited. However, given that India already has a substantial revealed comparative advantage in the export of IT and telecom services into OECD markets, any regulatory harmonisation and removal of non-tariff barriers (NTB) between the EU and India would arguably render market access for excluded low-income developing countries into the EU in such services that much more difficult in future. In addition to the incumbency advantages discussed above, the exemption from any wasteful sector-specific services regulation for Indian service suppliers would translate into reduced costs for such suppliers establishing their presence in European markets and a consequent decline in EU prices for those services. Assuming some degree of substitutability with services from excluded countries this would put competitive pressure on excluded country suppliers who would suffer lost sales and, most likely, a decline in their terms of trade as they reduced their prices on all their

sales. This is the terms of trade effect discussed in the last section of Part II for goods.

In what follows, we look at a few areas/sectors where they may be possibilities of an agreement between the EU and India and consider the ramifications of each for excluded countries:

IT: The Indian IT sector is already significantly liberalised and India also has a huge revealed comparative advantage in exporting IT services to the OECD. The composition of exports has also changed from a predominance of Mode 4 to an almost equal distribution between Modes 1 and 4. Any possible agreement could therefore involve pro-liberal provisions on both modes of delivery. This could further consolidate India's RCA in this sector, based as it is on India's highly skilled and cheaper workforce, to the detriment of excluded low income developing countries if they too had potential comparative advantage in the sector. However, most low income countries have little prospect of establishing software export capacity in the next couple of decades, so the damage is potential more than actual.

Banking, insurance and financial services: Given that the sector is moderately liberalised in India already, European firms would certainly seek greater market access, including the raising of investment caps and relaxation of regulatory requirements. A possible agreement could use the mechanism of the India-Singapore CECA wherein three specified Singapore banks have been allocated a separate quota of fifteen branches over four years, over and above the quota for all foreign banks. This would certainly facilitate European presence in the Indian market although whether this would be at the expense of banks from low-income countries is very unclear given the latter's weakness in the sector. Moreover, while Indian firms may also reciprocally get more *de jure* market access into Europe, one cannot be certain whether this would translate into actual market penetration in Europe, as it would be some time before Indian firms in this sector could win the confidence of European clients. Finally, if the FTA led to greater EU investment in India, this may raise fears of there being correspondingly less European investment in the excluded countries. The evidence of such re-orientation of investment is weak however – see below.

Mode 2: India has an interest in the export of health services and this manifests itself in the inflow of foreign patients to domestic hospitals and doctors. Such trade results in significant cost savings for patients and health insurers – see Mattoo and Rathindran (2005). Similarly, thousands of Indian students explore educational opportunities in Europe every year while European academic institutions are equally keen to set up shop in India or get into academic alliances with Indian schools[65]. Both these areas could be covered by liberal provisions in a possible agreement but in either case, excluded low income developing countries are likely to be adversely affected by such a development.

Notes

65 For instance the France-based ESCP-EAP European School of Management is looking at academic tie-ups with business schools in India and is also holding executive education programmes for corporates in India. Similarly, the European Business School, Germany was on a tour to India with the purpose of starting a business school in the country.

Chapter 6

The role of investment

The discussion so far has largely focussed on India's market access to the EU. The other dimension is the reverse trade flow, which assumes much significance in the context of a possible EU–India agreement and its impact on excluded low-income developing countries. The EU's strategic interests in most developing country markets are in Mode 3 and here it would be interesting to see if a possible EU–India agreement has separate provisions on investment in addition to coverage of Mode 3. In either case, given that European firms complain about being unaware of general conditions in the Indian market and the plethora of horizontal barriers plaguing investment in India, a possible agreement covering such issues could go a long way in switching the portfolio of EU investment in favour of India and possibly away from other low-income developing countries. In view of the well known positive effects of such investment in the recipient countries, such possible shifts in the flow of capital to India could be quite detrimental to the excluded low-income developing countries. The positive spill-over effects of economic integration on investment are documented in the literature (for example, see Brenton et al. 1999, Gao, 2005 and Feils and Rahman, 2008) and the excluded countries would be bereft of these as well.

As Schiff and Winters (2003) point out, integration has an impact on the overall investment climate within the PTA and this may in turn have a favourable effect on investment. Regional integration typically reduces the transaction costs of tradables more than those of non-tradables and if the former are more capital-intensive than the latter, trade liberalisation will increase the relative demand for capital and its rate of return. This in turn induces investment in the PTA. Moreover, deep integration may raise the efficiency of the financial sector, reducing lending margins and the cost of funds, thereby leading to higher investment, although, in truth, such financial integration is not easy to attain.

Since PTAs encompass reductions in regional trade barriers and investment restrictions, their impact on investment flows will ultimately reflect the impact of trade and investment liberalisation on location and firm-specific advantages. As Blomstrom et al. (1998) note, changes in location-specific advantages are potentially associated with liberalisation-induced changes in relative costs among member and non-member countries, changes in relative economic growth rates, altered investor perceptions about country-specific political risk, agglomeration economies, etc. Some of these changes will be the direct result of liberalisation initiatives while others will indirectly reflect the consequences of economic integration – economic integration will affect relative and absolute growth rates which, in turn, may have an impact on investment.

Motta and Norman (1996) show that economic integration, by improving market accessibility, induces outside firms to invest in the integrated regional bloc. Most of this invest-

ment is likely to take the form of intra-regional export platform FDI[66], including that emanating from excluded countries, with the investing firm supplying the majority of the countries in the PTA by intra-regional exports. They also show, however, that a net increase in inward investment in the PTA, from members and non-members, is not necessary. If there is intra-regional FDI prior to integration, increased market accessibility post-integration would lead to the rationalisation of intra-regional FDI through an investment replacement effect of FDI by outside firms. Intra-regional firms will switch increasingly to intra-regional exports.

The purpose of FDI may also be to take advantage of the local factors of production and these motives can be enhanced if a developing country forms an agreement with a developed country. For instance, the NAFTA, after 1994, had a profound impact on FDI into Mexico from countries outside the bloc, as this investment became a way to guarantee market access to Mexico's northern partners (Blomstrom and Kokko, 1997; Fernandes and Portes, 1998).

Finally, the removal of internal barriers within a PTA may stimulate vertical FDI, especially if the partner countries differ in their endowments. This aspect of North-South PTAs lies at the heart of Ethier's (1998a) theoretical exploration of the benefits of regionalism. With guaranteed preferential access to the northern market, the southern partner becomes an attractive destination for labour-intensive activities and thus attracts more investment, both from within and outside the PTA.

Ethier (1998b) further adds that the credibility of a government to announced reform can be crucial in attracting FDI – 'even a regional arrangement with only modest big-country preferences for the small country establishes an external commitment to reform that (weakly) binds future governments, thereby making the future preservation of reform (slightly) more credible'[67]. Moreover, even marginal preferences in trade agreements lead to investment re-orientation in favour of the partner country to the detriment of the excluded countries – 'suppose one country that would undertake reform anyway enters into a regional arrangement. Then direct investment producing intermediate goods for that country's partner will all be diverted there, and the country still remains a potential host for other direct investment. Less direct investment remains for other reforming countries, reducing their prospects for success and perhaps deterring some of them even from embarking upon reform'[68].

The empirical results in this area are somewhat ambiguous. The general conclusion is that the first phase of European integration was accompanied by a substantial net increase in both EC-related intra and extra-FDI and trade flows. Studies of the later stages of European integration have been more mixed in their findings. Pain and Lansbury (1997) cited some evidence that the Internal Market process of the EU may have diverted investment into the EU at the expense of other locations. Specifically, the level of inward investment in Europe by U.S. and Japanese firms was significantly higher since 1987 than might otherwise have been expected. Pain (1997) focused on the determinants of intra-EU FDI from the United Kingdom to investigate the diversion of British investment into the EU at the expense of the United States. His results suggested that the internal market pro-

gramme had a significant positive impact on the stock of UK FDI within the EU, especially in the services sectors. Barrell and Pain (1997) also found clear evidence that the EU Single Market Programme had raised the level of intra-EU FDI significantly. Brenton et al. (1999), on the other hand, found no evidence of FDI diversion perhaps because, as opposed to the studies above, the results from their gravity model was based on flows of FDI and not their stock.

In terms of the impact on individual PTA members, while no investment effects were found in the case of the UK (e.g. Mayes, 1983 and Grant, 1983), Ireland's membership in the EC stimulated direct investment from both EC and non-EC sources (O'Farrell, 1983). Similarly, Spain and Portugal benefited from significant increases in inward FDI as a result of EC membership (Baldwin et al., 1995) but Greece did not (Winters, 1996). However, Brenton et al. (1999) found no evidence that this increased investment in Spain and Portugal in the late 1980s significantly reduced investment flows to other European destinations. Further, FDI flows to CEECs in the 1990s did not have a clear negative impact on overseas investment in Spain and Portugal.

The North American experience of Mexico after NAFTA too suggests substantially more modest impact of PTA on extra-regional FDI stimulation than is associated with the earlier stages of EU integration (Blomstrom et al. 1998). At the same time, there is support for the European findings that trade and investment impacts will differ across countries within the integrating region. These empirical results thus serve as a caution against generalising from earlier experiences. As Blomstrom et al. note, 'the consequences of regional economic integration are sufficiently conditioned by inherited policies, as well as by existing macroeconomic conditions, to make extrapolation from historical experience very risky and potentially misleading.'

To summarise, there are certainly theoretical reasons to believe that the EU–India FTA will stimulate investment in India and that this will be strongly beneficial for the Indian economy. There are also some reasons to believe that investment elsewhere might contract and that this could be harmful for excluded countries. On the other hand, empirical evidence for such effects, especially the losses to excluded countries, is far from conclusive. Thus, while there is reason to consider these effects, there is little reason to expect them to be very harmful.

Notes

66 As Schiff and Winters (pp. 118, op.cit, 2003) point out, 'such platform investment is particularly likely if there are increasing returns to scale in production, making for lumpy investments that are viable only above a certain size'. Many services exhibit these characteristics.

67 Ethier (1998b) op. cit. pp. 1157.

68 Ethier (1998b) op. cit. pp. 1158.

Chapter 7

Conclusion

Services trade should be a major component of an EU–India FTA. Both parties have strong interest in the service sector and many barriers to mutual trade. If they achieve liberalisation, some benefits will probably spill over to other developing countries but especially some partners' gains in competitiveness will probably redound to excluded countries' long run disadvantage as Indian firms become established in the EU and difficult to displace. This will be more of a problem for middle-income than low-income countries, for most of the latter are not very plausible exporters in most tradable services anyway. Part of the effect may be felt via FDI, but the evidence of serious re-orientation of investment away from excluded countries is actually very weak. Finally, the chances of meaningful services liberalisation in the EU–India FTA are not particularly good.

Overall, the excluded countries should keep a watching brief on the EU–India talks and ask corresponding improvements in their own access to the partner markets. They should not presume, however, that they face a serious and pervasive disadvantage in services just because of the FTA.

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Part IV

Policy responses

This final part of the book 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 feasible to identify specific sectors under threat. Moreover, even if one could, it is usually difficult to identify and justify appropriate interventions to support them. Hence the advice is generic and general – but no less valid for that. It is basically for policies that would, even in the absence of an FTA between the EU and India, boost an excluded country's growth and economic flexibility by encouraging adjustment and change.

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 cooperation 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.

Chapter 2

Multilateral responses

The message of the previous section is not particularly encouraging: even if the shocks to excluded countries or sectors within them are material, there is not much that excluded country governments can do about them other than adjust and seek help from the offending parties. Their best hope is to negotiate, possibly by making market access concessions of their own, an attenuation of the harm they feel. Multilaterally, the situation is not quite the same.

The sum of the even small adverse effects on excluded countries may be significant and, acting together, the set of excluded countries will have a good deal of negotiating power if they choose to use it. Article 24 of the GATT offers one route into this negotiation, and it is far from definitive about what is WTO-consistent in the field of FTAs. Thus, for example, although the requirement to liberalise 'substantially all trade' is interpreted by the EU to mean the freeing up of 90 per cent of the partners' mutual trade, presumably, as with the EPAs, comprising 100 per cent of EU imports and 80 per cent of India's imports, this has never been tested in dispute or ruled upon by the WTO's Committee on Regional Trading Arrangements. The threat of a concerted challenge by excluded countries could cause a rethink by the partners. One should not under-estimate the change in customary practice that such a challenge would imply within the WTO. The convention has been one largely of mutual tolerance – we will not challenge your FTA if you do not challenge ours. And it will require considerable coherence among the group of excluded countries. Nonetheless, it is the view of many trade economists that the trading system would be a stronger institution if it took more seriously its principle of non-discrimination.

Outside the WTO, excluded countries may conclude that they should 'play the FTA game' harder themselves, negotiating hard and seeking access to deep and meaningful FTAs with the EU and India – and, indeed, anyone else – in ways that reduce the discrimination they face and support their own reform programmes. As we noted above, this will require concessions and will certainly require a serious input of diplomatic, political and technical resources. It may eliminate net distortions in the world economy and result in greater market access and deeper institutional reform of their economies, all of which will tend to enhance their economic performance.

On the other hand, they may reason that negotiating FTAs diverts attention and effort from the multilateral system. For example, resources are devoted to writing and reading this report rather than contributing to the success of the multilateral round, and regionalism may reduce the interests of the business sector in non-discriminatory trade reform and liberalisation. Moreover, if the response to the EU–India FTA is for excluded countries to try to negotiate further FTAs for themselves (as Baldwin's, 1997, Domino theory pre-

dicts), even small effects may be replicated many times over as the trading system fragments. Given that there is little reason to believe that we will be able to converge on free trade through the gradual accumulation of FTAs, the overall losses from proliferation could be quite serious. Nearly every country is excluded from nearly every FTA, so this cumulative effect is likely to gravitate to everyone's disadvantage eventually.

On this view, excluded countries 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. If they conclude that this is the route to pursue, groupings such as the Commonwealth may become important focal points of their efforts.

It would be nice to conclude with a definitive recommendation on the question of the correct stance for small and poor countries on FTAs and the trading system. However, that is not the subject that we were asked to explore here. Moreover, the evidence about the relative merits of these two approaches is complex and ambiguous, and both the policy communities and the economics profession are divided on them, so a thorough discussion must be postponed to another occasion.

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INNOCENT BYSTANDERS

Implications of an EU–India Free Trade Agreement for Excluded Countries

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The European Union, under its 'Global Europe' initiative, has since 2006 been pursuing trade agreements with its major global trading partners. An EU–India Free Trade Agreement is currently under negotiation; if successfully concluded it is likely to have knock-on effects on other countries' trade with both India and the EU, the trade of the 'innocent bystanders' excluded from the agreement.

The authors consider the implications of the EU–India Free Trade Agreement for various groups of other countries, including the ACP countries and those in South Asia, the latter group being most strongly impacted. The analysis considers not only trade in goods but also trade in services, and focuses not only on quantities but also on the prices at which trade is conducted.

The authors then consider how excluded countries might respond to the Free Trade Agreement, both at an individual level and at a systemic level.

COMMONWEALTH SECRETARIAT

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