

# Preface

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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

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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<sup>1</sup> 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.