

# **FTAs and Export Competitiveness:**

## **Policy Lessons from a Decade of WTO-plus Tariff Liberalisation**

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### **Introduction**

The COVID-19 pandemic and lockdown have severely worsened the investment and growth slowdown in the Indian economy that was already evident for some time now. In the midst of this unprecedented economic collapse, India has begun considering some of the preferential trade deals that were put off earlier due to considerable domestic pressure. The latter was owing to a growing acknowledgement that the shift in India's trade policy focus away from multilateralism towards preferential trade agreements (PTAs)<sup>1</sup> has played a major adverse role in the pre-pandemic domestic industrial slow down and the dramatically increased import dependence in the economy.

It must be noted that India was among the countries which had come to perceive PTAs as important tools for improving export competitiveness and accelerating industrial growth since the early- to mid-2000s, following the deadlock in the WTO negotiations. Three channels have been believed to be at work through PTAs: MFN-plus access to export markets; increased access to more “competitive” intermediate imports from the PTA partners; and increased FDI-led integration into global value chains (GVCs).

More than a decade has passed since the entry into force of both the India-ASEAN Free Trade Agreement (FTA) and the India-South Korea Comprehensive Economic Partnership Agreement (CEPA) in 2010. The India-Japan CEPA also came into effect in 2011. Against the backdrop of the objectives underlying these trade deals, this note

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<sup>1</sup> PTAs include bilateral and regional free trade agreements (FTAs), comprehensive economic partnership agreements (CEPAs), comprehensive economic cooperation agreements (CECAs), etc. Sticking to common parlance, we use PTAs and FTAs interchangeably here, including in the title.

briefly examines the impact of the WTO-plus tariff liberalisation carried out by India on her manufacturing sector trade performance. It then discusses how these trade agreements need to be urgently reviewed to limit further damage to the domestic manufacturing sector.<sup>2</sup>

### **The Nature of India's WTO-plus Tariff Liberalisation**

In the absence of an industrial policy, India's WTO-plus tariff liberalisation under these FTAs was carried out without any strategic coherence. In her FTAs with ASEAN, South Korea and Japan, India's tariff liberalisation in most consumer goods, capital goods and intermediate goods in the manufacturing sector went far beyond the country's WTO commitments. India also undertook greater tariff liberalisation and granted significantly higher margins of preference than many of her developing country PTA partners across the majority of industries.<sup>3</sup>

Rather than using trade policy as one of the tools to meet the country's industrial development objectives, tariff liberalisation had become a policy objective in itself under the dictates of a neoliberal philosophy of policymaking. There was no cognisance of the need to adjust trade policy to sustain existing domestic backward and forward linkages within the manufacturing sector. In the case of the strategically critical electronics industry too—which has become the top contributor to India's merchandise imports after oil—India's tariff liberalisation went beyond that under the WTO's Information Technology Agreement (ITA-1). Despite the official acknowledgement by the early 2000s that output and employment in the domestic electronics industry had been severely affected by the import surge under the ITA-1, the subsequent governments carried out deep and non-strategic tariff liberalisation under the PTAs.<sup>4</sup>

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<sup>2</sup> This Policy Brief is based on an in-depth study of the extent and pattern of India's tariff liberalisation under these major PTAs and the outcomes in India's manufacturing sector trade performance carried out in Francis (2020c). The author is grateful to Prof. Ramachandran, Prof. Chalapati Rao and Dr. Satyaki Roy for their comments on an earlier draft of this Policy brief. However, the views are personal and the usual caveat holds. The former study was sponsored as part of the ICSSR-funded ISID Research Programme 'Industrial, Trade and Investment Policies: Pathways to Industrialization'.

<sup>3</sup> See Dhar (2018) and Francis (2020c) for detailed analyses of the tariff liberalisation schedules under these trade deals.

<sup>4</sup> Analysis of ITA-1-plus liberalisation under these three FTAs can be found in Francis 2019c and Francis and Kallummal 2020.

In the case of some other sectors like textiles and clothing, plastic and plastic products, rubber and rubber products, cotton, silk, copper and copper products, etc. too, there seemed to be no coherent policy given that these product lines were kept in the negative lists of the PTAs with Korea and Japan, while most of them had already been liberalised under the ASEAN FTA. Given that ASEAN economies are deeply integrated with Japan and Korea through production sharing arrangements and value chains such that multinational corporations (MNCs) from the latter two countries can utilise the ASEAN-India FTA for gaining preferential market access in India, keeping such sectors in the negative lists of the India-Korea and India-Japan CEPAs became quite irrelevant.<sup>5</sup>

### **India's Global Export Competitiveness**

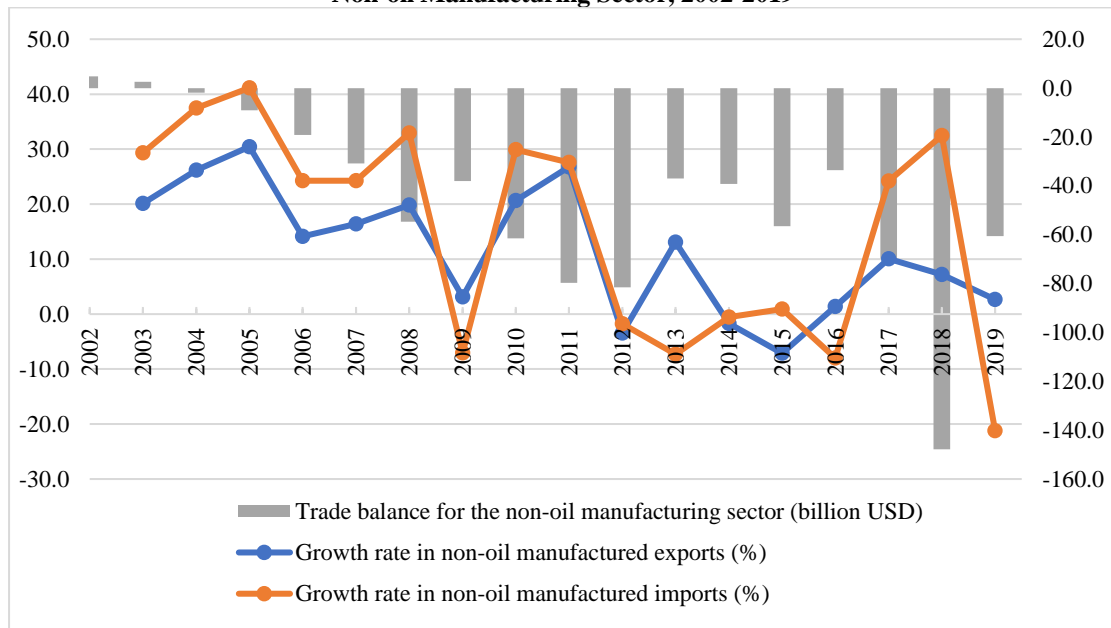
In spite of such broad and deep tariff liberalisation, India's global export performance has been slacking for several years now. The country's share in global merchandise exports has stagnated around 1.6%-1.7% since 2011. That is, India's export growth declined way before global merchandise exports declined by 3% in 2019 weighed down by the US-China trade tensions and slowing global economic growth. On the other side, India's share in global merchandise imports has risen fast and stood at 2.5% in 2019.

The slowdown particularly in non-oil manufactured export growth since 2011 gives us a clear indication at the macro level that India's export performance has suffered despite the additional opening up of export markets through FTAs (and in spite of the import liberalisation that has been carried out). At 75%, the share of non-oil manufactured exports in India's merchandise exports was much lower in 2019 than the peak in 2003. On the other side, with the continuous rise in the share of non-oil manufactured imports in total imports from 2002, non-oil manufacturing sector trade balance—which had turned negative from 2004, has increased massively.

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<sup>5</sup> See the particular case of electronics industry discussed in Francis (2019c) and Francis and Kallummal (2020).

**Figure 1: Trends in Exports, Imports and Trade Balance for the Non-oil Manufacturing Sector, 2002-2019**



Source: Author's calculations based on WITS UN Comtrade data

Another telling indicator of India's weak export competitiveness is the fact that even as India's non-oil manufactured exports seemingly increased in capital and technology-intensive sectors (like vehicles and parts, non-electrical machinery, organic chemicals, pharmaceuticals, electrical machinery, iron and steel, articles of iron and steel, etc.), the share of India's manufactured exports going to the mature developed country markets has declined. It is in the case of developing country markets that India's exports have been relatively strong.<sup>6</sup>

Moreover, as many as six out of India's top ten manufactured exports were also among the top ten non-oil manufactured imports, namely, gems and jewellery, electrical machinery and parts, non-electrical machinery and parts, organic chemicals, iron and steel, and vehicles and parts. The other significant manufactured imports were: optical, medical and other professional equipment and their parts; fertilisers; inorganic and miscellaneous chemicals, apart from metal and metal products. Among these, the

<sup>6</sup> Given that the less developed and developing country markets are generally less challenging for developing country firms to serve, a large part of this shift towards South-South trade can be explained by the inability of Indian firms to compete against foreign products in her domestic market. The latter may be due to different factors, including the lack of a domestic level playing field against imports and the lack of dynamic competitiveness discussed in the last section. It has been observed that in the case of certain segments like telecom products, some Indian indigenous companies have been competing against the same foreign products in export markets. Therefore, multiple factors are likely to be at play in different industries.

electrical machinery sector, comprising electronics products, has seen the largest increase in import share.

India's dependence on China as the single largest source of many of these non-oil manufactured imports has been a cause of concern for some time now. However, in the recent past, there has been a decline in the share of imports from China in the case of some industries. But this does not seem to point to any sudden or significant increase in India's competitiveness vis-à-vis China. This is because, there has been noticeable increase, since 2017, in the shares of India's imports originating from Hong Kong, China, Singapore and Vietnam. There is evidence to believe—especially in the case of electronics products (spread across HS chapters 84, 85 and 90)—that Chinese exports have been diverted and have been entering India through these three countries.<sup>7</sup> The latter is a clear attempt on China's part to divert the increased focus on its rising bilateral trade deficit with India. The increase in the shares since 2017 of Hong Kong, China and Singapore appears to signal a reversal to their traditional entrepot roles.<sup>8</sup> But for countries other than Hong Kong, China, it is amply evident that India's FTA with ASEAN is facilitating this re-routing. In addition to electronics, there is potential re-routing of Chinese exports via India's ASEAN partners in iron and steel through Indonesia, vehicles and parts through Singapore, and inorganic chemicals through Vietnam. This calls for immediate policy interventions in the context of India's already imbalanced bilateral trade with ASEAN, as seen below.

### **India's Export Competitiveness vis-à-vis Major FTA Partners**

India's capacity to compete against these FTA partners in her domestic market clearly declined over the last decade after these FTAs came into force (Table 1). This is true except for the least developed countries (LDCs - Cambodia, Laos, Myanmar and Vietnam) and the Philippines. The ratio of India's trade balance to total trade deteriorated in the case of South Korea and Japan as well.

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<sup>7</sup> See Francis and Kallummal (2019).

<sup>8</sup> While Hong Kong, China and Singapore had traditionally played the entrepot roles, their shares in India's imports had declined during 2011-16, immediately after the AIFTA came into force. See also Dhar and Rao (2020).

**Table 1: India's Pre- and Post-FTA Trade Balance/Total Trade Ratios vis-a-vis Major Partners**

Country	Trade balance/Total trade (%)				
	2002-08	2016-18	2009	2018	2019
Brunei	-79.7	-83.1	-90.2	-79.8	-82.2
Cambodia	92.5	46.0	83.5	49.8	62.8
Indonesia	-37.2	-60.9	-43.4	-60.8	-55.0
Malaysia	-44.3	-30.3	-17.2	-32.6	-24.8
Myanmar	-63.8	19.3	-70.0	41.8	30.8
Philippines	48.8	42.4	34.1	39.5	49.2
Singapore	5.5	-2.4	5.3	-23.5	-16.2
Thailand	-4.5	-31.9	-23.7	-36.5	-23.8
Vietnam	72.3	13.3	61.1	-12.6	-14.9
Lao PDR	87.4	-67.6	98.6	34.9	83.6
ASEAN-5	-16.0	-29.6	-17.4	-36.8	-27.7
CLMP	16.2	13.6	12.9	-6.1	43.5
<b>ASEAN -10</b>	<b>-13.6</b>	<b>-21.9</b>	<b>-14.5</b>	<b>-31.5</b>	<b>-25.0</b>
<b>South Korea</b>	<b>-41.2</b>	<b>-58.3</b>	<b>-37.1</b>	<b>-60.7</b>	<b>-55.2</b>
<b>Japan</b>	<b>-24.2</b>	<b>-46.2</b>	<b>-35.1</b>	<b>-52.4</b>	<b>-45.2</b>
<b>China</b>	<b>-35.9</b>	<b>-71.0</b>	<b>-49.4</b>	<b>-69.3</b>	<b>-59.7</b>
<b>Total</b>	<b>-19.1</b>	<b>-23.6</b>	<b>-20.2</b>	<b>-31.4</b>	<b>-16.6</b>

Note: Indonesia, Malaysia, Singapore, Thailand and Vietnam constitute ASEAN-5, and CLMP stands for Cambodia, Laos, Myanmar and the Philippines.

Source: Author based on WITS Comtrade

It is critical to note that despite some improvement observed in these ratios for 2019, India's trade with the major PTA partners has continued to remain highly adverse. Further, the ratio worsened between 2018 and 2019 in the case of Vietnam.

Overall, ASEAN-5's aggregate share in India's global imports went up from less than 8% in 2008 to 10% in 2016. This increased further to about 12% in 2019 over a period of just 3 years, due to the jump in the shares of Vietnam and Singapore mentioned above. Between the pre- and post-CEPA phases, South Korea's share in India's global imports too increased steadily. Although Japan's share in India's imports declined after the CEPA came into force, this too has seen an increase from 2018.

A disaggregated analysis on of India's imports from the FTA members based on their stage of processing clearly establishes that India's imports of intermediate products did go up substantially between the pre- and post-FTA phases for all the major ASEAN partners, as was expected. This happened in the case of imports from South Korea and Japan also.<sup>9</sup>

<sup>9</sup> Some discrepancy was observed (in terms of the larger shares of capital goods imports within them) in the electrical and non-electrical machinery as well as transport equipment sectors. This is owing to the fact that under the given classification scheme, a number of parts and component product lines in

Despite the increased imports of intermediate products, India has failed to make significant market access gains in these FTA partner countries' markets. Post- FTA, India's market share increased most significantly in the LDCs (Myanmar, Brunei, Lao PDR) and the Philippines. However, Myanmar was the only ASEAN country in which India attained a share of even 5% of the former's global imports during 2017-18. Even this dropped to 3.8% in 2019. India's market share increase was even lower in Malaysia, Thailand and Indonesia.

Wherever India's market share in the five major ASEAN partners increased in some manufacturing sector product groups, India's average shares remained below 5% of their respective global imports during 2017-18 and 2019. The large majority of the market share increase that India witnessed in the major ASEAN partners was in agricultural products.<sup>10</sup>

In the case of South Korea, even as South Korea's global imports nearly doubled between the pre-CEPA phase and 2019, India's share in these imports has stagnated around one per cent. As a share of Japan's global imports too, India's market share has remained stagnant below one per cent throughout the post-CEPA phases.

Overall, the evidence after a decade of their implementation establishes that the major underlying objective of these PTAs to increase India's export market share for her manufactured products has not been met. On their own, neither any short-term 'productivity gains' that might have accrued through cheaper intermediate imports, nor the WTO-plus market access enabled through these PTAs have helped to improve India's manufactured sector competitiveness in a sustainable manner.

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these sectors have been categorised as capital goods, rather than as intermediate products. See Francis (2020c).

<sup>10</sup> One exception was transport equipment exports to Indonesia, which became the only manufactured product group that garnered a more than 5% share in a PTA member's global imports during 2017-18. Another important exception was electrical machinery exports to Vietnam, for which India's market share had increased to 12% in 2019. (*ibid.*)

## **The Trade-Investment-Technology Interface Behind Export**

### **Competitiveness**

Literature on comparative industrial development experiences gives ample evidence that coordinated industrial policy support is indispensable for increasing firm-level, industry-level and economy-wide productivity conditions for acquiring and maintaining dynamic competitiveness. Policy support to create and sustain these conditions is also fundamental, both to attract FDI (whether the tariff-jumping/market-seeking or efficiency-seeking type), and to ensure that whatever FDI comes in, will translate into greater industrial growth of the desirable kind, that is, industrial growth with maximal domestic value addition and minimal foreign exchange leakages from the economy.<sup>11</sup>

Uniquely, all the preferential trade liberalisation which India undertook since the mid-2000s has involved East and South East Asian economies, which are deeply integrated with regional/global value chains in several industries. By granting duty-free market access to such production centres with ‘first mover advantages within GVCs, India’s non-strategic MFN-plus trade liberalisation under these FTAs removed MNCs’ incentives for tariff-jumping FDI into India. Moreover, such tariff liberalisation led to perverse incentives for domestic and foreign producers’ investments in actual manufacturing in India (as opposed to assembly). This was because of the absence of ‘other policies and factors that incentivise local manufacturing under tariff-free trade’.<sup>12</sup> Such factors relate to the need for a threshold level of technological capabilities among domestic firms/workers for getting included in GVCs, let alone for achieving technological catch-up through GVCs.<sup>13</sup>

In the absence of coherent policies for improving the micro and macro productivity conditions needed for maintaining dynamic competitiveness, the significant increase in the availability of duty-free intermediate and other products enabled through the PTAs has played a major role in India’s manufacturing sector slowdown. Due to the absence

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<sup>11</sup> See the large amount of evidence on the nature of FDI inflows into Indian manufacturing sector and the nature of operations of foreign invested firms in Rao and Dhar (2018), Verma (2015), Verma and Ranganathan (2016), Joseph and Ranganathan (2016), and Saraswathy (2016).

<sup>12</sup> This was most starkly witnessed in the case of the electronics industry. See Chapter 4 in Francis (2019c).

<sup>13</sup> See the arguments and the literature cited in Chapters 1 and 3 in Francis (2019c).



of strategic industrial policy support for building upon existing local value chain segments, domestic producers were put in disadvantageous domestic market access position against imports. The fact that India's tariff liberalisation did not simultaneously incorporate non-tariff market access barriers<sup>14</sup> is also relatable to the absence of a strategic industrial policy. The PTAs thus led to the disintegration of domestic backward and forward linkages in the Indian economy with adverse outcomes, as reflected in the across-the-board increased import dependence (including in top exporting industries).<sup>15</sup>

### **Policy Lessons and Recommendations**

It is evident that the shift in India's trade policy towards preferential trade agreements did not automatically deliver the build-up in domestic capabilities and capacities required to make our production base more competitive. India must urgently carry out a holistic review of these PTAs even if a handful of domestic firms are found to have benefited from increased exports under them. Further, the evidence of significant adverse impact of the existing FTAs do not give any basis to the renewed calls for India to re-join the Regional Comprehensive Economic Partnership (RCEP) negotiations before policy support leads to an increase in manufacturing value addition in the country, including by indigenous firms.

Dynamic competitiveness requires prudent and coordinated industrial policy support that will re-build the domestic forward and backward linkages across Indian industries and continuously improve their technological capabilities. Towards this, as other country experiences have established, the government has to both invest and incentivise large domestic (in particular, indigenous) investments in product and process R&D, commercialisation of innovations, industry-specific infrastructure, etc. There has to be a coherent policy framework to enable indigenous firms to upgrade technologically towards more energy efficient processes and products, as well as to increase their domestic market access that will help them achieve economies of scale to compete with imports.

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<sup>14</sup> Kallummal (2020).

<sup>15</sup> This observation is also supported by the trends available in the literature on the stagnant growth in the Indian manufacturing sector. For instance, see Roy (2016).

In the interim, India must utilise the safeguard measures available under these PTAs to protect the domestic industry against import surges. In order to dynamically review the measures, the Department of Commerce should monitor the volume and pricing trends in all top manufactured imports from the PTA partners at the product level.

It is of significance to note that ASEAN has an FTA and an investment agreement with Hong Kong, China, which came into force in June 2019. It is therefore of paramount importance that the Department of Commerce re-work the Rules of Origin in the ASEAN FTA to redress and pre-empt increased re-routing of state-supported Chinese exports to India. The Department of Commerce must analyse the firm-level customs data available with them to assess the extent to which non-ASEAN firms are using the ASEAN FTA.

Further, Article 13 b(iii) of the ASEAN FTA allows policy measures “to protect critical communications infrastructure from deliberate attempts intended to disable or degrade such infrastructure”. Given that the telecom sector is the backbone of all digital infrastructure and is therefore strategically critical for national security, this Article may be used to protect against cyber threats posed by Chinese firms exploiting the ASEAN FTA.<sup>16</sup>

With the economy undergoing the worst economic contraction since independence, any new trade negotiations must be put off until the government sorts out domestic policies for indigenous manufacturers. This is also critical given the heavily accelerated digital transformations happening across sectors. Digital markets have several structural exclusionary features centred around data and digital intelligence, which create entry barriers.<sup>17</sup> Industrial policy support is essential, particularly for SMEs. Such support

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<sup>16</sup> This suggestion on Article 13 b(iii) under the ASEAN FTA is with reference to goods trade and seeks to address the issue of telecom equipment and parts and components imports from China, using the ASEAN FTA route. However, despite the India's cyber security threats surely go beyond China; in the context of digital infrastructure, India faces similar national security vulnerabilities from all foreign telecom, software and other digital providers, including the US and European players. The implications of existing and future foreign investments (into manufacturing or services) for cyber/national security must be addressed through data protection rules and FDI rules. See the discussion in Francis (2020b).

<sup>17</sup> Francis (2019a). For some examples of how to integrate digital economy policies into a broader industrial development strategy, see Francis (2020a).

must range from those in the context of access to finance, technological upgradation needed to meet climate change challenges, digital transformation and so on, to those related to FDI, government procurement, data protection, public digital infrastructure, IPR regime, etc. All these policies have to be coherently managed to signal preference for innovation-led domestic manufacturing that will also address India's employment crisis, and support indigenous companies in particular, to maximise domestic value addition and minimise foreign exchange leakages from the economy.

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