

PLAYING CATCH-UP: Looming Trade Questions for India and South Asia

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Historically, South Asian countries, including India, have been rather timid in their overall approach to international trade. The latest example of this is the decision by India to opt out of the Regional Comprehensive Economic Partnership (RCEP), with stated concerns including a possible surge of manufactured imports from China and dairy imports from New Zealand. India's neighbours have been even more hesitant to embrace trade as a vital cog in development, erecting barriers to regional and global trade, arising from fears about Chinese and Indian imports. All of this has made South Asia the most protected as well as the least integrated region in the world.

Even as South Asia hesitates, its highly competitive East Asian neighbours are striding ahead, raising the bar for South Asia to attract foreign direct investment (FDI) and access global markets. Vietnam, in particular, shows strong recent evidence of deepening its already firm commitment to international trade, concluding free trade agreements with the European Union (EVFTA), the United Kingdom and with the ASEAN plus five countries (RCEP). Earlier, Vietnam signed the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), which came into force for Vietnam in 2019. Further from home, the renegotiated US-Mexico-Canada Trade Agreement (USMCA) has rewritten some rules of trade between the three countries, potentially affecting South Asian countries. Moreover, the US-China trade war, along with President Biden's recent presidential order to maximise government procurement of "Made in America" goods and services, provides a mixture of some new opportunities and some potential new hurdles for South Asian countries.

In addition to preference erosion, the next decade will likely witness major global shifts in trade flows arising from efforts to secure robust supply chains in critical products such as semi-conductors and pharmaceutical products for western countries, commitments to net-zero carbon emissions by 2030, and from developments in areas such as artificial intelligence, 5G telecom, biotechnology and renewable energy.

The question now is, how can India address the likely significant erosion in market access and changing incentives for investment? In addition, instead of being reactive to the changing environment, could India take a more pro-active approach to building economic alliances—addressing both market access as well as technology access—that take into account the rapid developments in advanced technologies? This note poses a number of questions and initial hypotheses in this regard, based on preliminary data analysis, setting the agenda for future exploration. It will be followed up by a series of policy papers that will analyse many of the questions that it poses. The notes will also attempt to draw implications for some other South Asian countries, to the extent that they are affected by the changing global alliances as well as India's approach to these alliances.

THE IMPACT OF THE EU-VIETNAM FTA ON SAR

India is already competing with Vietnam as well as neighbouring countries such as Bangladesh and Pakistan to supply exports to the European market. At present, both India and Vietnam supply about 1% of EU's total imports from the world. The new EVFTA, that came into force on August 1, 2020, exerts additional pressure on India in apparel, leather goods, footwear and fisheries sectors. Vietnam's spurt in manufacturing production and exports, arising from increases in productivity, proximity to regional shipping routes, and lower wages (*vis-à-vis* China), coupled with lower or even zero tariffs that it already enjoys in Southeast Asia and will perhaps now enjoy in the EU and the UK market, could squeeze Indian exports in these markets. Given the new preferential tariffs on 99 percent of goods and services under the EVFTA, Vietnam is also likely to expand its export basket to Europe (i.e., its exports could expand on the "extensive margin"). This means that India could potentially face greater competition in exports of pharmaceuticals, ICT goods and electronics, especially mobile handsets. The only



respite for India, Bangladesh and Pakistan comes in the form of a 'staging period' ranging from four to eight years in the EVFTA, especially on apparel and footwear exports from Vietnam. How will South Asian countries maintain their market shares in the EU? Can they increase their productivity to compete with Vietnam?

Following Brexit, the United Kingdom signed a free trade agreement with Vietnam that came into force on May 1, 2021. Until January 1, 2021, the Brexit transition period allowed the UK to enjoy access to the EU market and the EU's own free trade agreements, including the EVFTA. The UK and Vietnam agreement basically applies the existing EVFTA, with the exception of some rules that permit the UK to apply an entry-price system on imports of vegetables and fruits. In addition, both parties will implement the remaining stages of tariff reductions mentioned in the EVFTA in a continuous manner under the UK-Vietnam FTA instead of re-starting the process from its date of entry into force. The text also withdraws some articles already applied under the EVFTA and also prohibits Vietnam nationals from providing legal services in the UK to government departments or matters relating to the government/crown. As is to be expected, the UK-Vietnam FTA is likely to enhance their trade relationship and increase competition for goods and services from India, Bangladesh and Pakistan.

THE WITHDRAWAL FROM RCEP BY INDIA

Research shows that deeper trade agreements tend to attract additional investment inflows. The EVFTA is a deep trade agreement that covers services and investment in addition to trade in goods (the EU-Vietnam Investment Protection Agreement will enter into force after ratification by all EU member states). Thus, Vietnam is likely to attract European FDI in key manufacturing and services sector in the future, not only to access the Vietnamese market, but also improve access to the huge market provided by RCEP countries. The same incentive will also push other RCEP countries to invest in Vietnam, in order to improve their access to the European market.

How does this affect India? It creates additional incentives to bolster the supply chain within East Asia/RCEP through investments in Vietnam. Since India does not enjoy the same level of trade preferences in the EU and RCEP countries as Vietnam, it stands to lose some of the investment. In fact, even nimble Indian firms are likely to be on the lookout for new investment opportunities in Vietnam, as a way to improve market access in RCEP, EU and CPTPP countries.

THE IMPACT OF USMCA ON SAR

Another major development in global trade has been the renegotiation of the North American Free Trade Agreement into what is now known as the US-Mexico-Canada Trade Agreement (USMCA). The USMCA, which came into force on July 1, 2020, is a "worker-first" agreement with new rules on procurement, rules of origin, intellectual property rights, state-owned enterprises and digital trade. It also redefines the existing supply chains in the automobile sector by mandating use of locally manufactured components to qualify for tariff exemptions (up from 62.5 percent under NAFTA to 75 percent under the USMCA). This may impact India's position in the automobile value chain, reflected in exports of motorcar parts and accessories as well as steel and aluminium products. Another provision in the USMCA that strengthens the rules of origin in the textile industry could potentially hurt apparel/textile exports from South Asia, including Bangladesh, as well as East Asia. Ex-post analysis on the impact of the USMCA on SAR will be helpful in pinpointing and addressing likely losses in market share.

In general, US trade agreements tend to follow a standard template covering a wide range of different subject areas. This template was enhanced by the USMCA, and is likely to set the pace and direction of subsequent trade negotiations by the US Administration. Against this backdrop, and with continued differences on several trade issues between India and the US, an agreement on a comprehensive India-US FTA seems unlikely in the foreseeable future.



THE FALLOUT OF THE US-CHINA TRADE WAR ON INDIA

Finally, rising wage costs in China as well as the continued US-China trade war under the new Biden administration have encouraged companies to move production and source imports away from China. These moves to decouple supply chains have been further pushed by the COVID-19 pandemic that began in China. As a result, American, Japanese and South Korean firms are relocating away from China, especially to Southeast Asian countries such as Vietnam, Thailand and Malaysia. Even Chinese firms are relocating to Southeast Asia, especially when it comes to more labour-intensive production. This is part of the larger 'China-plus-one' strategy. India, too, has an opportunity to attract these relocating firms. The same goes for other South Asian countries, especially Bangladesh, whose economic star is on the ascendant. But, thus far, little of the trade diverted away from China has benefited South Asia, in contrast to Vietnam.

HOW CAN INDIA RESPOND TO THESE GLOBAL CHANGES?

In the face of these rapid changes, India needs to respond strategically and without too much delay. Even as it will be handicapped by not being part of RCEP or sealing an FTA deal with the EU, it also has new vistas opening up, including the US-China trade war, and, more broadly, the global push to diversify supply chains. The potential economic deepening within the Quad group also holds promise. In addition to looking out for itself, India will benefit from considering the economic interests of its South Asian neighbours, who have basically been bystanders in these global realignments. Some preliminary thoughts are spelt out below.

Trade Connect

Post-Brexit, the United Kingdom has engaged bilaterally with most of its largest trading partners, and signed trade deals with the European Union, Japan and Canada, covering eighty percent of its total trade. It is also expediting deals with Australia and New Zealand as it aspires to participate in the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP).

For the UK and India, both opting out of major trading blocs, an FTA sounds like a win-win. The UK is one of India's largest and historic trade partners. A free trade agreement between the two could be more likely than, say, between India and the EU, since the latter brings more contentious issues into play. A bilateral India-UK FTA can build on their existing, extensive economic interlinkages. From an Indian perspective, such an FTA could improve market access in sectors such as apparel. It could also help India negotiate better terms in services trade, especially those related to movement of professionals, and in attracting FDI from the UK. There is also scope for greater collaboration in science, R&D and Fintech.

Although more difficult, India will need to address the roadblocks to deals with the EU and the US. One option is to start with softer deals, and backload serious commitments on issues where there are major differences of opinion. Another option is to negotiate a limited agreement, and agree to keep working on a more comprehensive arrangement.

Investment Connect

India's investment to GDP ratio peaked at around 42 percent in 2007, a part of the heady growth story of the 2000s. Since then, it has been steadily declining, and was less than 30 percent of GDP in 2019. India needs more FDI as well as domestic investment in order to get back to a high growth path and create more and better jobs. Thus, in an attempt to attract FDI and domestic investment across a range of sectors, India started a Production Linked Incentive (PLI) scheme in 2020.



Since trade and investment are intimately connected, India can try to better leverage current and future trade agreements in the hope of attracting more diversified and greenfield foreign investment. For example, India and its Japanese and Korean partners have been reviewing their respective Comprehensive Economic Partnership Agreements (CEPAs), exploring deeper investment and production linkages in value chains.

While some of this may occur, FTAs alone will not be enough to trigger the investment spinoff. India's size makes it a very attractive market for investment, but it still needs more diversified, job creating and greenfield FDI flows. This will require India to dispassionately assess the strengths and weaknesses of its FDI regime, including the predictability of its regulatory and tax environment.

Regional Connect

The pandemic has revealed the importance of global cooperation and supply networks. A consensus appears to be building around the need for supply chains that are more diversified, more resilient, and perhaps more regional and local. India, as the largest country in South Asia, can take advantage of these openings to enhance economic relations with its neighbours. It can encourage trade and creation of regional value chains

by investing in neighbouring countries to enhance their export capacity and competitiveness, accompanied by an increase in imports from them. Possible sectors for Indian investment in the neighbourhood could include health, IT services, garments and food processing, but this list is a dynamic one. India can also encourage FDI from neighbouring countries; for example, Bangladeshi FDI to India's North-Eastern Region. Creation of such regional value chains can also create more possibilities for India's neighbours to benefit from the new trade and investment partnerships that India is considering.

A CONTINUING AGENDA

The world is moving ahead rapidly to reshape trading and economic relationships. As in the past, India and the rest of South Asia are struggling to absorb what is happening, let alone taking proactive action of their own. This note has presented an agenda for deeper analysis, based on an initial reading of global realignments. Future research will also provide an opportunity to present, in some detail, the policy options for India (and, where relevant, other South Asian countries) in response to these changes.