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THE MYTHS AROUND FREE TRADE AGREEMENTS

Relevant for: International Relations | Topic: RCEP and India

India's decision not to join the Regional Comprehensive Economic Partnership (RCEP) has led to an avalanche of write-ups, editorials and interviews. Most looked at the effect of the decision around four issues: exports, investments, integration into the global value chain (GVC) and domestic industry. Let us use another source for insights — experiences countries have had with free trade agreements (FTAs).

First, do FTAs lead to an increase in exports? Few economists have argued that by not signing the RCEP, Indian exporters would miss on exporting to RCEP countries. They forget that India has FTAs with the Association of Southeast Asian Nations (ASEAN), Japan, South Korea, and three-fourths of the bilateral trade already happens zero duty. India also has a small preferential trade agreement with China.

But the mere signing of an FTA does not guarantee an increase in exports. If import duty in the partner country is high, there is a likelihood of an increase in exports by 10% when this duty becomes zero. But chances of exports increasing are low if import duty of the partner country is low at 1-3%. From this count, FTAs are of no use for exporting to Singapore, Hong Kong, as regular (Most Favoured Nation) import duties are zero. FTAs with Malaysia, Japan, Australia, New Zealand, Brunei, etc. benefit few product groups only as more than 60% of imports into these countries happen at zero duty for all countries. There is little additional market access. Most critics have missed this detail.

But even the high import duties coming down to zero through the FTAs do not guarantee exports. Japan reduced duty from 10% to zero for Indian apparels through an FTA in 2011. But India's apparel exports to Japan have nosedived from $255 million in 2010 to $152 million in 2018. Blame it on Japanese non-tariff barriers to trade (NTBs) such as special sourcing requirements. But NTBs are generally not negotiated in FTAs. Countries have to resolve these bilaterally. To summarise, FTAs cut import duties, but this is only one of many factors that decide if exports will increase.

*Does a lower import duty regime help in getting significant investments? Most experts have argued in its favour. Let us look at evidence from the automobile industry in Australia and India. Australia, in 1987, produced 89% of the cars it used. It protected the car industry through a high 45% import duty. But the share of locally produced vehicles came down as the duties were reduced. Today, Australia imports nearly all cars as tariffs came further down to a 5% level. Most manufacturers such as Nissan, Ford, General Motors, Toyota, Mitsubishi, etc. which produced cars in Australia shut shop.

But, India could attract significant investments in the car sector on account of high import duties. This resulted in the development of an indigenous car and auto component industry. Now, with the car industry maturing, India can think of lowering import duties to promote competition.

Most investments are a result of the package such as tax cuts, cheap land, power, etc. offered by the host country. If a country is not the most efficient economy, some level of an import wall helps in getting external investments. Without an import wall, many firms may shift production to the more efficient FTA partner countries for exporting back to the home market. But the quality of investments increases as a country moves towards becoming a more efficient economy. Such countries are in an ideal position to become manufacturing and services hubs.

Third, do FTAs ease entry into GVCs? Most commentators have lamented that by not signing RCEP, India will miss becoming part of GVCs. It is not so simple. Actual value chain activities are time critical. And a country cannot become a significant part of such value chains unless it has efficient ports, customs, shipping, roads and a regulatory compliance infrastructure. GVC production also requires harmonisation of product and quality standards.

For these reasons, FTAs alone do not make a country part of a value chain, which will be disrupted if a shipment is delayed or is of non-standard quality. ASEAN, Japan and Korea constitute the core of the Asian regional value chain. But despite FTAs with these countries, India has a weak presence in the electronics, machinery or apparels value chains.

Four, is Indian industry protectionist? Consider the impact of reducing import duty on an engine from 20% to zero for an FTA partner. Cheaper imports may replace products from domestic industries. But, if the duty on a product is low at say 3%, the local industry may not care much about the duty elimination through any FTA. Countries that have reached this stage are comfortable doing FTAs with fewer worries.

An FTA’s possible impact on the economy or exports is subject to many caveats. The FTAs can ensure market access to only the right quality products made at competitive prices. Improvement in firm-level competitiveness is a must. The government can help by ensuring lower duties on raw materials and intermediates than on the concerned finished products. It can set up an elaborate quality and standards infrastructure for essential products. Most countries regulate imports through such requirements and not through tariffs.

Finally, about India turning inward. India ranks higher than the U.S., Japan, and China in the trade openness ratio, the globally accepted measure. The ratio is the sum of all imports and exports as % of GDP — India (43) is more open than the United States (27), Japan (35), and China (38).

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