Policy Brief #2017/06

Two Unequal Partners? Challenges and Benefits of the EU-India Free Trade Agreement

Talks between India and the EU about a Free Trade Agreement (FTA) have been going on for a while now and have been anything but easy so far. Both sides could benefit from a bilateral FTA and make a strong case for free trade. However, there are many hurdles to overcome before the EU and India will be able to agree to a deal.

Bollywood, yoga, call centers… for many westerners, India stands primarily for esotericism and the relocation of services, and less for industrial production and trade in goods. One reason for this is the fact that despite its size, India is a dwarf as far as world trade is concerned. A mere 1.6 percent of global merchandise exports come from India. Moreover, despite being a member of the World Trade Organization (WTO), the country is comparatively closed. Although the government under Prime Minister Narendra Modi is open in principle when it comes to economic liberalization, in India, there are also doubts about the real advantages of free trade agreements (FTA) for the country.

This is probably one of the reasons why negotiations for an FTA between the EU and India, which started in 2007, have been sluggish so far. India is currently the EU's ninth largest trading partner. In contrast, the EU is India's largest trading partner. In 2016 reciprocal trade volumes for goods stood at around €77 billion. There is definitely more potential here, with trade barriers persisting on both sides. A deep FTA would lead to the reduction of tariffs and so-called non-tariff barriers, which could achieve considerable welfare gains.

A possible trade agreement would stand on shaky historic ground

India has had a longstanding relationship with Europe through its trade and colonial history. Although the French, Danish, Dutch and Portuguese have been present in India since the 15th Century, India's economic, political and cultural relationship with Europe has been anchored around the United Kingdom (UK). Not surprisingly, UK's joining the EU facilitated a wider and deeper relationship between the two regions. The EU-India strategic partnership was launched in 2004 with a focus on security, trade and cultural exchange. While its relationship with the EU looks promising on paper, India's outlook is shaped by its intellectual elites brought up with an Anglo-Saxon worldview. There are some exceptions, such as defense cooperation, where the Indo-French relationship is decades old and time tested. Of late, economic ties with continental European countries have improved with Germany, India's largest trading partner in Europe. Although biased towards the UK owing to its long historical ties, India's trade with Europe is varied reflecting the strengths of each country. While trade with the UK is dominated by IT and financial services, trade with Germany is dominated by automotive and industrial products. This makes an EU-India FTA hard to negotiate at a supranational level.

Moreover, India was a late entrant into the free trade camp with its deep skepticism of giving market forces free rein. The historical experience of colonialism with its purported free market and laissez-faire approach drained the wealth of erstwhile rich kingdoms in the sub-continent. With one foot in the free trade camp and the other in a state controlled (if not directed) economy, India's FTAs with other Asian countries such as Japan or Malaysia have not boosted its exports. With a partner continent like the EU, which enjoys economies featuring high labor productivity, superb infrastructure and an enabling government, discussions on economic cooperation begin on unequal footing.

Indian economic interests are a combination of promoting sectors where it can meet the global standards (like IT or business services) while protecting traditional sectors, such as agriculture, where almost half of its workforce are engaged. For India, acceptance as a data secure nation and easier access to temporary visas for high-qualified Indian workers are important issues, too.

The EU hopes for better market access for European businesses in India, especially in the service sector and in government procurement. Tariff reductions, in the automotive industry for example, improved protection of intellectual property rights, and the issue of investor protection are also at the top of the list.

The EU and India would both benefit from a free trade agreement

Negotiations on an FTA between the EU and India have been ongoing since 2007, albeit with limited success, and were actually even suspended in 2013. As mentioned above, there are a range of difficult issues on both sides, including visa regulations, data security, investor protection and market access. The fact that India has begun letting bilateral investment treaties with individual EU member states expire does not really help matters.

When Donald Tusk, President of the European Council, Jean-Claude Juncker, President of the European Commission, and Indian Prime Minister Shri Narendra Modi met at the 14th India-EU Summit in New Delhi in October 2017, they re-confirmed their intention to establish a free trade agreement. In their joint statement, the leaders also "noted the ongoing efforts of both sides to re-engage actively towards timely relaunching negotiations." However, negotiations had not presumed formally until now. The chief negotiators are scheduled to convene in November this year to find a way to move ahead.

If the EU and India were to agree on a comprehensive trade agreement, bilateral tariffs and non-tariff measures would be substantially reduced. India could increase its economic performance measured by GDP by 1.3 percent annually, as demonstrated by a recent study of the Ifo Institute on behalf of Bertelsmann Stiftung. Based on India's GDP in 2015, this would mean an increase in GDP by US$28 billion.

Annual GDP increases for the EU would amount to 0.14 percent on average. Based on the EU's GDP in 2015, this would mean an increase by US$23 billion. Individual Member States would benefit to very different degrees: with nearly US$5 billion, Germany - which is India's biggest trade partner in the EU - would be able to achieve the second highest absolute increase after the United Kingdom (US$5.2 billion). In contrast, the effects for Croatia would be a mere US$0.02 billion. No EU Member State would suffer overall negative effects, which is by no

TABLE 1: **Effects of a deep EU-India FTA on real GDP in the EU-28, India and selected third countries** (in percent)

	GDP in 2015		Annual real income change			Real wage change in %
	total, in bn. US$	per capita, in US$	in %	in bn. US$	per capita, in US$	
India	2,183	1,688	1.30	28.44	22.00	1.55
EU28	16,266	32,064	0.14	22.50	44.35	
Belgium	459	40,456	0.45	2.06	181.56	0.57
Ireland	227	48,940	0.39	0.89	190.98	0.26
Slovakia	86	15,893	0.23	0.20	36.40	0.24
Malta	9	21,540	0.21	0.02	45.81	0.30
United Kingdom	2,865	44,118	0.18	5.22	80.37	0.21
Estonia	23	17,425	0.17	0.04	29.52	0.21
Slovenia	43	20,712	0.17	0.07	34.63	0.19
Latvia	28	13,729	0.16	0.04	21.96	0.24
Greece	193	17,657	0.16	0.30	27.82	0.18
Sweden	484	48,966	0.15	0.75	75.52	0.15
Finland	231	42,159	0.15	0.35	64.52	0.16
Germany	3,371	41,267	0.15	4.98	61.02	0.16
Denmark	291	51,424	0.14	0.42	73.70	0.17
Cyprus	19	21,531	0.13	0.03	29.01	0.17
Czech Republic	182	17,330	0.13	0.23	22.20	0.13
Netherlands	751	44,333	0.11	0.85	49.91	0.11
Spain	1,221	26,327	0.11	1.33	28.63	0.12
Hungary	118	12,021	0.09	0.11	11.32	0.09
Romania	175	8,807	0.09	0.16	8.11	0.09
Italy	1,819	29,847	0.09	1.67	27.39	0.10
Luxembourg	58	103,187	0.08	0.05	86.49	0.10
Lithuania	42	14,318	0.08	0.03	11.65	0.11
France	2,423	37,728	0.08	1.95	30.36	0.10
Poland	481	12,662	0.07	0.33	8.58	0.08
Austria	373	43,547	0.07	0.25	29.23	0.07
Bulgaria	47	6,582	0.07	0.03	4.39	0.07
Portugal	198	18,984	0.06	0.11	10.99	0.06
Croatia	49	11,551	0.05	0.02	5.75	0.06
USA	17,968	55,904	0.00	0.20	0.63	
Rest of Asia	8,489	7,340	−0.01	−0.87	−0.75	
BRICS w/o India	15,045	8,415	−0.02	−3.18	−1.78	
Rest of Europe & Turkey	1,808	19,249	−0.02	−0.48	−5.08	
World	**72,318**	**10,849**	**0.06**	**46.29**	**6.94**	

Note: The table shows simulation results of the deep EU-India scenario, i.e. all sectors receive the deep non-tariff measures treatment. The real income change of regions is a GDP-weighted average of the country-specific real income changes in that region.

Source: Calculation ifo Institute. GDP data for the year 2015 stem from the World Economic Outlook.

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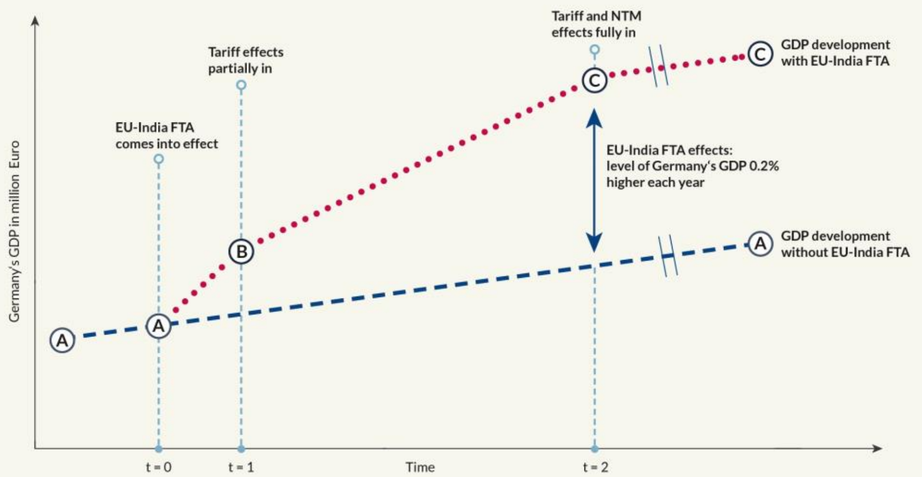
Effects of an EU-India FTA on the level of Germany's GDP



GDP = Gross Domestic Product FTA = Free Trade Agreement NTM = non-tariff trade measures

Source: ifo graphic based on WTI (2016).

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means a foregone conclusion when calculations of this kind are made.

Taking Germany's GDP development with and without an EU-India FTA as an example, the graph above shows that all effects mentioned are long-term effects and would therefore only be observed after the free trade agreement had been in force for around 10-12 years.

…but there will also be losers at the sectoral level

At the sectoral level, the Indian business services and textiles sectors would - in absolute terms - be among the winners from a trade agreement and increase their value added by US$6.5 and US$3.6 billion respectively. In these sectors, India has a clear comparative advantage. Correspondingly, on the losing side, there are sectors where Indian firms are barely competitive in relation to their European competitors, such as motor vehicles or minerals (value added –US$1.6 billion and –US$1.2 billion respectively).
This result is especially clear in trade relations between India and Germany: As far as individual sectors are concerned, in Germany the motor vehicle sector and the machines and equipment sector would benefit the most, with their value added increasing by up to US$1.6 billion and US$1.5 billion respectively. Here, German firms have a competitive edge in India. In contrast, business services, wearing apparel and textiles in Germany would be sectoral losers. Their value added would drop by US$559 million, US$425 million and US$373 million respectively.

The gains in value added in Germany thus appear to mirror the losses in India and vice versa. This could point towards stronger specialization by both countries for specialization in both countries on those products which are especially competitive in the respective market, in case the free trade agreement is concluded – with all the advantages and disadvantages this implies for their national economies, e.g. in regard to structural change on the labor markets.

A quick detour: The EU-India FTA and Brexit

Let us not forget that on June 23, 2016 the United Kingdom voted to leave the European

TABLE 2: **Changes in sectoral value added in India, the EU-28 and Germany (million US$)**

	India: Top-5 winning sectors	Change in value added (million US$)		India: Top-5 losing sectors	Change in value added (million US$)
1	Business services nec	6,473	1	Motor vehicles and parts	1,576
2	Textiles	3,588	2	Machinery and equipment nec	1,523
3	Trade services	3,413	3	Public administration/Defence/ Health/Education	755
4	Wearing apparel	3,051	4	Chemical, rubber, plastic products	627
5	Public administration/Defence/ Health/Education	2,557	5	Dwellings	365
	EU-28: Top-5 winning sectors	**Change in value added (million US$)**		**EU-28: Top-5 losing sectors**	**Change in value added (million US$)**
1	Public administration/Defence/ Health/Education	4,151	1	Wearing apparel	–2,580
2	Machinery and equipment nec	4,082	2	Textiles	–2,540
3	Minerals nec	3,446	3	Petroleum, coal products	–1,888
4	Motor vehicles and parts	3,109	4	Business services nec	–1,490
5	Metals nec	2,315	5	Oil	–1,304
	Germany: Top-5 winning sectors	**Change in value added (million US$)**		**Germany: Top-5 losing sectors**	**Change in value added (million US$)**
1	Motor vehicles and parts	1,576	1	Business services nec	–559
2	Machinery and equipment nec	1,523	2	Wearing apparel	–425
3	Public administration/Defence/ Health/Education	755	3	Textiles	–373
4	Chemical, rubber, plastic products	627	4	Leather products	–189
5	Dwellings	365	5	Petroleum, coal products	–93

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Union. Thus, any future trade agreement between the EU and India will no longer include the United Kingdom. We have followed up on this line of thought in a separate scenario. This is based on the assumption that there would be a "hard" Brexit, whereby the EU and the UK would reintroduce tariffs, and non-tariff barriers would increase to the level observed between other WTO members.

A look at the general welfare losses registered by Brexit shows that these would cost the average European (non-UK) citizen "only" about USD 68 a year, whereas the average Briton would suffer a loss of USD 858. In comparison, India would remain almost unaffected by the Brexit with USD -0.1.

With the UK being a major beneficiary of the deal, it makes sense that an FTA between India and Europe excluding the UK would be worth less than a deal that includes the UK. Our analysis shows that a deep agreement with the EU27 yields only USD 17.30 for the average Indian citizen, which is USD 4.70 less than what a deal including the UK would generate.

TABLE 3: **Welfare Effects of an EU-India FTA under Brexit**

	Simulated annual per-capita income increase (in US-$)					
Scenario:	Benchmark w. Brexit	EU-India FTA under Brexit			UK-India FTA under Brexit	EU-India FTA w/o Brexit
Depth:	Deep	Tariff only	Shallow	Deep	Deep	Deep
India	–0.1	0.1	8.9	17.3	4.7	22.0
United Kingdom	–857.7	1.2	–0.4	1.0	88.2	80.4
EU27	–68.4	5.5	19.9	40.2	–0.7	39.1
Belgium	–200.9	38.6	121.1	190.8	–4.6	181.6
Ireland	–1138.6	18.7	89.0	206.1	–11.0	191.0
Slovak Republic	–23.8	17.2	22.3	39.6	–0.4	36.4
Malta	–189.9	1.6	24.5	46.4	1.5	45.8
Estonia	–54.8	2.2	16.2	28.3	0.5	29.5
Slovenia	58.0	3.8	26.9	34.6	0.0	34.6
Latvia	–28.6	3.3	12.6	21.6	0.5	22.0
Greece	–23.7	0.8	25.1	28.4	0.1	27.8
Sweden	–141.1	12.6	35.2	76.4	–0.6	75.5
Finland	–74.9	5.1	34.8	64.8	–0.1	64.5
Germany	–80.4	13.0	32.5	63.5	–1.3	61.0
Denmark	–150.3	2.8	19.7	72.5	–0.1	73.7
Cyprus	–151.6	–0.4	16.6	28.4	0.5	29.0
Czech Republic	–36.2	6.0	12.4	22.9	–0.7	22.2
Netherlands	–135.7	6.0	25.0	52.5	0.0	49.9
Spain	–62.1	1.7	10.0	27.8	–1.6	28.6
Hungary	–21.7	1.7	7.8	11.6	–1.0	11.3
Romania	–12.1	0.6	5.3	7.6	–0.1	8.1
Italy	–34.2	3.1	12.3	28.3	–0.1	27.4
Luxembourg	–652.3	–2.9	36.0	83.3	2.4	86.5
Lithuania	–25.4	0.6	6.0	11.4	0.3	11.7
France	–59.2	0.8	12.9	30.7	–0.1	30.4
Poland	–22.0	0.6	4.0	8.6	0.0	8.6
Austria	–36.9	4.8	15.9	30.3	–0.5	29.2
Bulgaria	–11.9	0.4	2.6	4.1	0.1	4.4
Portugal	–43.4	–0.6	3.9	10.5	0.0	11.0
USA	0.4	0.7	0.5	–1.4	–1.7	0.6
BRICS w/o India	0.8	–0.4	–0.9	–1.5	–0.3	–1.8
Rest of Asia	0.7	–0.2	–0.2	–0.6	–0.2	–0.8
Rest of Europe & Turkey	–2.7	–1.3	–2.2	–2.8	–2.1	–5.1
World	–12.5	0.2	2.7	5.3	1.5	6.9

Note: The table shows simulation results of various EU-India FTA scenarios. The simulation starting point (benchmark) is a situation where, starting from the situation in 2011, the UK exits the EU (Brexit) and Croatia enter the EU (not shown for expositional reasons). Brexit is assumed to eliminate all NTM reductions between the EU and the UK and the tariff the EU imposes on UK products is as w.r.t. the US (i.e. MFN tariffs). In the respective scenarios, all sectors receive treatment. The expected annual per capita real income increase of a region is a population-weighted average of the country-specific real income changes in the region.

Source: ifo 2016.

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In other words, for India, Brexit lowers the potential gains from an FTA with the EU by 21% or more than a fifth. This is substantial and must be expected to weaken India's interest in the undertaking. Table 3 also shows that an agreement with India without the UK can actually benefit some EU members. For example, Germany would see larger gains from the FTA if Britain were to be excluded. The reason for this is that it would face less competition from UK competitors in the Indian market, such as for automobiles, for example. Other countries would lose, such as Luxembourg, which offers financial products that are complementary to those provided by Britain (e.g., depository services). Of course, this does not mean that Brexit would be beneficial in the first place for any of the countries listed below except some third countries.

Beyond economic benefits – The strategic value of an FTA between the EU and India

The benefits for India of a trade agreement with the EU cannot be measured by the growth of one sector or another alone. Access to the European Common Market, even if it excludes the UK, would pay off in the future especially when Indian firms improve their productivity and can compete with European players. India's agricultural sector is the back bone of its labor force, but it cannot remain the main employer as productivity levels improve through increased automatization. Progressive easing of agricultural tariffs would allow gradual growth in productivity and resilience to compete with global markets.

India should take a leap of faith with a region with which it shares economic and political values. Values that are becoming rarer in a world faced with a US administration in favor of protectionism, and a rising China whose hegemonic ambitions are being eyed with suspicion by other Asian countries.

The EU in turn could further push its "pivot to Asia" in trade and strengthen its position in one of the most dynamic regions through an FTA with the soon-to-be most populous country in the world. India has a relatively young population and huge economic potential. The agreement could help EU companies to have their share in the subcontinent's prospect growth story.

However, in order to resume negotiations and move ahead, both sides will need to compromise. For example, the EU should try and lay out fair conditions under which India may be accepted as a data-secure nation. In the IT sector in particular, concessions should be made regarding travel restrictions for Indian professionals.

India will also need room to protect its agricultural sector, which still employs about half of the country's workforce. In the textiles and wearing apparel sectors especially, some EU Member States (e.g. Italy, Spain, Portugal) could suffer job losses and will need help from the EU to mitigate these effects. Generally speaking, the EU should keep in mind that India is still a relatively poor developing country and needs a generous amount of time and flexibility to adapt to the structural changes brought about by a potential FTA.

Lastly, a free trade agreement between two major economic regions would also be an important signal in favor of free trade and economic cooperation in general. In times of Trump and Brexit, the world economy is in dire need of this.

Further reading

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V.i.S.d.P

Bertelsmann Stiftung
Carl-Bertelsmann-Straße 256
D-33311 Gütersloh
www.bertelsmann-stiftung.de

Dr. Stefan Empter
Phone: +49 5241 81-81137
stefan.empter@bertelsmann-stiftung.de

Andreas Esche
Phone: +49 5241 81-81333
andreas.esche@bertelsmann-stiftung.de

Dr. Thieß Petersen
Phone: +49 5241 81-81218
thiess.petersen@bertelsmann-stiftung.de

Picture: Varshesh Joshi / Unsplash.com

Authors

Dr. Cora Jungbluth
Program Shaping Sustainable Economies
Bertelsmann Stiftung
Phone: +49 5241 81-81482
cora.jungbluth@bertelsmann-stiftung.de

Murali Nair
Program Germany and Asia
Bertelsmann Stiftung
Phone: +49 5241 81-81521
murali.nair@bertelsmann-stiftung.de

Felix Vemmer
Nova School of Business and Economics, Lisbon

Prof. Gabriel Felbermayr, PhD
Ifo Institute & LMU Munich

Prof. Devashish Mitra, PhD
Syracuse University & CESifo

Dr. Rahel Aichinger
Ifo Institute

Dr. Jasmin Gröschl
Ifo Institute