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Regional Comprehensive Economic Partnership: An Analysis of its Impact on the Indian Economy

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Abstract

Then President George W. Bush announced in 2008 to join trade talks with a group comprising Brunei, Chile, New Zealand, and Singapore that had reached a trade agreement in 2005. Later, in 2008, Australia, Vietnam, Peru Canada, Japan, Malaysia, and Mexico joined the talks, making twelve countries in all, for what became to be called Trans Pacific Partnership (TPP). TPP talks intentionally excluded China. The TPP was successfully negotiated. But in early 2017 after president Trump pulled out the other 11 members signed the agreement, now called the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP). Meanwhile another group of nations centred around ASEAN and including Australia, China, Japan, Korea and New Zealand, have have agreed to another trade pact, the Regional Comprehensive Economic Partnershipo (RCEP). India did not sign the agreement though it had participated in the negotiations. The effect of this on the Indian economy is analysed.

Keywords

TPP, CPTPP, RCEP, India, China

Then President George W. Bush announced in 2008 to join trade talks with a group comprising Brunei, Chile, New Zealand, and Singapore that had reached a trade agreement in 2005. Later, in 2008, Australia, Vietnam, Peru Canada, Japan, Malaysia, and Mexico joined the talks, making twelve countries in all, for what became to be called Trans Pacific Partnership (TPP). TPP talks intentionally excluded China. The TPP was successfully negotiated. But in early 2017 after president Trump pulled out the other 11 members signed the agreement, now called the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP).

> RCEP is the first free trade agreement between China, Japan, and South Korea, three of the four largest economies in Asia.

Negotiations for another trade group were conceived at the 2011 ASEAN Summit in Bali, Indonesia. Negotiations for this, called the Regional Comprehensive Economic Partnership (RCEP), were formally initiated during the 2012 ASEAN Summit in Cambodia. RCEP has 15 members, the 10 ASEAN members, many of whom were excluded from TPP, and Australia, China, Japan, New Zealand, and South Korea. These 15 countries account for about 30% of the world's population (2.2 billion people) and 30% of global GDP ($26.2 trillion) in 2020. RCEP was signed on 15 November 2020. RCEP is the first free trade agreement between China, Japan, and South Korea, three of the four largest economies in Asia.

India participated in the negotiations finally did not sign the agreement.

Three main reasons have been advanced for India not joining RCEP.

1. India’s deficit has increased with countries with which it has signed bilateral trade agreements. So, the fear is that India’s trade deficit would increase, particularly its deficit with China.

2. Fears raised by manufacturing and farming interests in India about competition especially from cheap imports from China with which country India already runs a large trade deficit. Indian policy makers believed that there was not enough protection for its domestic industries under RCEP.

3. It was believed that past trade agreements had resulted in de-industrialisation. Further de-industrialisation would make it difficult

for the government to achieve its objective of increasing the share of manufacturing in GDP and so reach its employment generation goals.[1]

More recently, border tensions with China may have been a factor to not join a trade agreement championed by it, and perhaps dominated by it.

Trade agreements and deficits

The argument that the deficits have increased because our partners have benefitted more these agreements than India has that would reflect badly on the negotiating ability of the Indian negotiators. This could be because they are not coordinating with producers so that they do not get concessions in sectors of interest to these producers. We show below that this is not the case.

Developing countries seek to grow rapidly and so they need to maintain high rates of investment.

We now discuss why the country has been running deficits with its RTA partners.

It has been known for almost 70 years that trade deficits are a reflection of the macroeconomic situation in a country and not because of trade policy. When expenditure in a country is greater than its output or, in other words, investment is greater than savings, then imports will be greater than exports and there will be a trade deficit.[2] Only policies that change the savings investment or the expenditure output situation will affect the trade deficit, but not trade policy.

There is a further question as to whether deficits are necessarily bad. Developing countries seek to grow rapidly and so they need to maintain high rates of investment. Since savings are likely to be low at their low levels of income, these will be insufficient to finance the desired investments. The gap has to be met by foreign capital inflows. That is the rationale for foreign inflows whether of aid or even partly of foreign direct investment.[3] China perhaps may be the only developing country to run trade surpluses from early in its development journey; others including India have run deficits.

The argument that the trade deals signed in the past have raised deficits is mistaken.

[1] It has been conjectured that the current state of tension with China played a role in India's rejection, though this has not officially been given as one of the reasons for the rejection.

[2] We know from national income accounting that output can be used for consumption investment or exports and the demand for some of them can be met by imports so that Y=C+I+X-M, abstracting from the government for the moment. Y is output and it could be used for consumption, I is investment, X is exports and M is imports. Also from the expenditure side income can be either consumed or saved, namely Y=C+S. So expenditure minus output implies that I-S=M-X.

[3] See Rosenstein-Rodan, P.N. (1943), Problems of Industrialization of Eastern and South-Eastern Europe, Economic Journal, Vol. 53, Issue 210/211, p 202-211

Trade agreements merely change the direction of trade and so change the distribution of the deficit among the trade partners. For instance, suppose India's imports are 150 and exports 100 and the trade deficit is 50. Also suppose India has two trade partners, A and B, with whom it trades equally. So, it exports 50 to each and imports 75 from each and so has a deficit of 25 with each. After India signs a trade agreement with A the proportion of its trade with A will increase and with B will decrease. Suppose now 60 per cent of its trade is with A and so 40 per cent with B. Then India's exports to A will be 60 and its imports 90 so deficit will be 30. It will export 40 to B and import 60 and the deficit with B will be 20. Total deficit remains at 50 but now deficit with A has increased to 30 and decreased with B to 20. We see that trade policy has not affected the total deficit, but its distribution among the trade partners. But again there is no *a priori* reason that the deficit would increase with countries with which India has signed an agreement.

> The total deficit would remain the same so long as the savings investment situation does not change

Also, there is no reason, a priori, that the deficit will increase proportionately with partner and non-partner countries. It could be that the deficit with the partner countries increases while it decreases with non partner countries. This would happen if imports are now bought from the agreement partner rather than the other country. But the total deficit would remain the same so long as the savings investment situation does not change. India's overall trade deficit has been rising because of macro-imbalance and so the balance has worsened against most of India's trading partners. As long as the savings investment situation does not change the total deficit will not change. All trade policy does is to redistribute the deficit. This redistribution is not a reflection of poor negotiation by India's negotiators or unfair practices by the agreement partners.

India's Trade with Partners of Regional Trade Arrangements (RTA)

India's exports to her RTA partners[4] remained less than $10 billion till 2001, increasing only marginally since 1962. However, in 2002 there was an unprecedented jump. The average rate of growth of exports to this set of countries is 11.5% between 1962 and 2014, while it is 18.6% since 2000.[5] A similar story applies to imports from these countries; however, except

[4] The RTA partners whose trade with India is examined are ASEAN, Bhutan, Japan, Malaysia, SAFTA, Singapore, South Korea, Sri Lanka,.

[5] For a detailed analysis of the effect of trade agreements on India's trade see Agarwal Manmohan and Sunandan Ghosh (2017) The Effect of Regional trade Agreements on India's Trade in Manmohan Agarwal, Jing Wang and John Whalley (eds.) The Economies of China and India "Cooperation and Conflict, Volume 1: China and India: The International Context and Economic Growth, Manufacturing Performance and Rural Development, World Scientific, Singapore.

for a few year in the early 1990s India experienced a trade deficit, though, not at an alarming level. But, India's trade deficit surged abruptly to $13 billion in 2005, from $3 billion in 2004, reaching $55 billion in 2014.India's overall trade balance increased from under $10 billion till 2002 to 14 billion in 2003 and over 40 billion in 2005 and over 130 billion in 2014. So the increase in India's deficit with its RTA partners was part of the increase in its overall deficit, as it has usually been about a third of its overall deficit. The increase in the deficit was because initially the high growth resulted in a surge in investment while savings increase lagged so that the investment savings gap rose. Later it continued to rise as savings declined. More recently, the trade deficit has decreased as investment has fallen further.

In brief, two features stand out in India's trade with its RTA partners. First, both imports from and exports to the RTA partner countries have grown exponentially since the new millennium, essentially before the signing of the agreements. This suggests that the agreements may have merely ratified what was happening. This behaviour of trade refutes the idea that India's trade negotiators did a poor job of the negotiations and did not cater to the needs of Indian manufacturers. Second, the share of trade, either export or import, has grown as well indicating a larger trade with the RTA partners since the late 1990s.

Indian manufacturing

Great concern has been expressed about the behaviour of manufacturing in India. This, however, is part of a general feature of developments in the last three decades. For a sample of 11 countries we note that the share of manufacturing in GDP was almost constant and then there is a sharp fall after the financial crisis of 2008 (Table 1). Subsequently again the average is almost constant. There are large declines in the share for some countries such as Brazil, Nigeria and South Africa, while there are smaller decreases in China, Indonesia etc.

The Indian share was roughly constant between 1991 and 2013 with some cyclical movement which had a peak in1996. Since then it has declined.

Share of manufacturing valued added in GDP in selected countries

	1991	1996	2001	2007	2013	2018
Brazil	22.1	13.1	13.1	14.2	10.5	8.4
China				32.4	30.7	27.2
India	15.7	17.6	15.3	16.9	15.3	13.7
Indonesia	21.0	25.6	30.8	27.0	21.0	19.7
Kenya	10.4	11.8	9.8	12.8	10.7	7.5
Korea	25.2	24.7	24.9	25.5	27.8	25.4
Malaysia	25.5	27.8	29.3	26.1	22.8	21.5
Mexico	18.9	20.2	18.0	15.9	15.8	17.3
Nigeria	19.5	19.1	13.9	8.4	8.9	11.5
South Africa	21.0	18.4	17.6	14.4	11.6	11.8
Tanzania	8.2	6.3	9.5	8.8	9.1	7.6*
Average	18.7	18.5	18.2	18.4	16.7	16.5

*These values are for 2017.

Source: World Development Indicators, World Bank

Furthermore, the liberalisation after 1991 did not change the share of the manufacturing sector. The correlation between the share of different sectors in manufacturing output in 1995 and 2011 is .87 significant at more than 1 percent level.[6] Clearly, while some companies might have become bankrupt after the liberalisation most companies in each industrial sector were able to adjust and so the industrial structure did not change significantly. It is believed that the trade pacts that India has already signed have been responsible for the slow growth of manufacturing in recent years and signing of the RCEP would have dealt a further blow to the sector. It is said that productivity in the sector is low so that it cannot meet foreign competition. It is important to recognise that the FTA with Sri Lanka was signed in 2002, with Singapore in 2005 and with ASEAN in 2004. Those with Japan. Korea and Malaysia were signed in the period 2010-11.

The share had been declining from its peak in 2006 much before these later FTAs were signed. Furthermore, the share of manufacturing in GDP has declined in two of the three countries with which India signed FTAs, Malaysia and Japan. There doesn't seem a credible case that past FTAs have contributed to the decline in manufacturing's share in GDP.

Exports of manufactures

India's exports had performed very well after the 1991 liberalisation which had seen a sharp decrease in import duties. The share of exports of goods and services in GDP increased from about 7 per cent in 1990 to 24.1 percent in 2008 and, after a slight dip, to 25.4 per cent in 2013. Since then it has been declining and fell to 18.7 percent in 2019. The increase in the earlier period occurred despite the reduction in import duties.

The share of manufacturing output exported increased gradually from about 10 percent in 1995 to about 18 percent in 2011. [7] An important feature of this performance was the substitution of domestic inputs by imported inputs. The share of domestic and imported inputs in gross value of output was 64.7 and 7.6 percent respectively in 1995. The share of imported inputs increased to 12.7 and that of domestic inputs fell to 59.9 percent respectively in 2011. The correlation between share of output exported and share of imported inputs in gross value of output in different sub-sectors of manufactures was .76 in 2011, which is significant at the 5 percent level.[8]

[6] See Agarwal Manmohan and Aritri Chakravarty (2017) Growth of the Manufacturing Sector: Future Constraints in Manmohan Agarwal, Jing Wang and John Whalley The Economies of China and India " Cooperation and Conflict, Volume 1: China and India: The International Context and Economic Growth, Manufacturing Performance and Rural Development, World Scientific, Singapore.

[7] Manmohan and Chakravarty (2017) ibid.

[8] Agarwal and Chakravarty (2017) ibid.

Manufacturing and RCEP

It took 8 years to negotiate the RCEP and the tariff cuts are to be implemented over a 20 year period. Other countries seem confident of their ability to face competition. If Indian manufacturing cannot raise the sector's productivity over the period it does not behove well for the possibility of the share of manufacturing to increase and without increased productivity it will be very difficult to achieve the higher growth that the country aims for.

Very inefficient companies might not have been able to adjust and so might have become bankrupt

There are fears that some industries will have to close down. But the experience since the1991 liberalisation shows that whole industries are not inefficient. Some companies within each industry were able to adjust so that the overall industrial structure did not change. Obviously, very inefficient companies might not have been able to adjust and so might have become bankrupt. But since the share of manufacturing in GDP did not go down it implies that other more efficient industries expanded, which is a desirable outcome.

Trade liberalisation would also lead to consumers having access to cheaper goods which would increase their welfare. Cheap mobile phones often imported or made with cheap imported components have made it possible for small scale producers such as electricians and plumbers to establish contact immediately with their consumers. This has made the provision of such services more efficient. Mobile phones have also made possible direct benefit transfers that could reduce corruption.

Success in manufacturing today requires that companies be part of global value chains. This means that they must be able to effortlessly and without bottlenecks send intermediates to India and then send the processed output to other destinations for further processing. As we have seen above there is a positive relation between share of imported inputs in output and share of output exported. Higher tariffs in India implemented over the last two years makes the inputs imported for further processing costlier as an import duty is charged on their import, and so would make the processed output non-competitive and India an unattractive partner for locating parts of global value chains.

RCEP and weakening China-India economic ties

India's rejection of signing the RCEP treaty has been accompanied by a number of steps to loosen the economic ties between China and India. We now examine how such 'decoupling' will affect the two economies. We first examine the effect of weaker trade ties. The goods that India exports to China are goods in which India has a revealed comparative advantage, namely goods that it also exports to other countries. These goods are sold in competitive international markets. Similar is the case for Chinese exports to India. The implication of this is that this allows for substitution. Suppose there are countries, A and B; A produces and exports a good that is exported by India and B is another country that imports that good and imports it from A. Suppose India no longer exports to China. Then China would import the good from A. Now that B has been cut from its supply source it would turn to India to import the good. So all that has happened is that India now exports to B rather than China and China imports the good from A rather than India. Similar shifts between suppliers and demanders would occur if India stops importing a good from China.

Weakening even decoupling, of economic relations between China and India is unlikely to significantly affect either economy.

Such shifting has been the reason why historically sanctions by individual countries, even one as powerful as the US, have not worked. Even when sanctions have been applied universally such as against South Africa's apartheid policy, it took a long time for the sanctions to lead to a change in South Africa's policy; and even that is controversial whether the sanctions had any effect at all.

US sanctions have worked in many cases when they have been tied to the role of the US dollar. The threat by the US to sanction financial institutions willing to finance trade by the country has a debilitating effect as it chokes off quite a few trade substitution policies. India has no comparative tool; actually, the Chinese currency is stronger.

We now analyse the effects of a rupture of financial relations between the two countries. In the past India's trade deficit with China has been financed by Chinese foreign direct investment (FDI) into India. If such FDI is limited then India will have to pay for the imports from China by transferring dollars from its foreign exchange reserves. Since the deficit is much smaller than these reserves this should not be a problem.

Chinese FDI into India has come into many start-ups, particularly those in the technology areas. Indian start-ups seem to have earned by now a strong reputation and withdrawal of Chinese FDI may create some initial hiccups, but not one that will have strong adverse effects. In brief, weakening even decoupling, of economic relations between China and India is unlikely to significantly affect either economy.

Conclusions

We find that trade liberalisation after 1991 had resulted in faster growth. Moreover, this growth was accompanied by rapid growth of manufacturing. The manufacturing sector also had a stellar export performance as the share of exports in manufacturing output increased.

> Growth would strengthen India and so we are not convinced that there is a political case for rejecting RCEP

The growth after the trade liberalisation did not have strong effects on the industrial structure. Better run companies in each sector adjusted to the increased competition following the liberalisation. The performance faltered only after 2013. We also found that there was a strong relation between the use of imported inputs and export performance. Past experience suggests that being a part of RCEP would have boosted economic performance. Now it will be difficult to participate in global value chains.

Weakening or even decoupling economic ties between the two countries is unlikely to significantly affect either of the two economies.

The discussion here has been based on an economic analysis of the possible effects of RCEP. More recently, a political element has been added because of border disputes with China. We would just like to suggest that many of the other countries which have signed the treaty have disputes with China. A possible reason for not signing the treaty would be the belief that RCEP would benefit China more than them and obviously they do not hold this view. It is doubtful that China would benefit more than India. Chinese imports from and exports to India are a larger share of India’s imports and exports than they are of China’s imports and exports. Furthermore, as we have noted above, liberalisation helped India’s growth particularly of the manufacturing sector and exports. Growth would strengthen India and so we are not convinced that there is a political case for rejecting RCEP.

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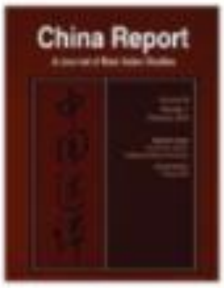

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