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From the ringside

Preferential Trade Agreements

**Stumbling blocks or building blocks?**

India seems to have fully embraced the new paradigm of Preferential Trade Agreements (PTAs). The report of the India-China Joint Study Group presented to the two Prime Ministers embarks us on the complex endeavour of India-China PTA or preferably a Comprehensive Economic Co-operation Agreement (CECA). The CECA with Singapore is round the corner. We have also commenced negotiations with MERCOSUR group comprising Brazil, Argentina, Uruguay and Paraguay. Negotiations with Thailand are underway as also with the ASEAN countries based on the framework agreement. The share of international trade under preferential access conditions now exceeds 55%. The European Union and the NAFTA having led the way in creating large trading blocks has spurred others on the same path.

India's efforts to enhance its trade profile deserves encouragement. While India's trade to GDP ratio following policy changes since 1991 might have increased significantly, yet, according to the World Development Indicators, it was still around 32% (31.76% to be exact) of GDP in 2003. This is less than the figure of 25% contained in the RBI Report. However, adhering to the WDI data, there are only three countries that had a lower trade-GDP ratio in 2003, namely Syria, Burundi and Sudan. India was narrowly beaten by Burkino Faso in terms of trade-GDP ratio and even Bangladesh which has a trade-GDP ratio of 34.02%. These figures are surprising in the context of the popular applause on our trade performance. Of course, our export-import volume is much larger but expressed as a percentage of GDP our achievement thus appear modest.

As India hurtles in embracing more preferential arrangements, some basic issues remain unresolved. Why are we finding PTAs more attractive than non-discriminatory multi-lateral arrangement? Because PTAs are smaller, any opening is partial and thus seemingly less threatening to domestic interests? Or that they do not create "transitional shocks" to domestic interest groups even though productivity and efficiency enhancement would remain more limited? Are we entering into these PTAs believing that some liberalisation is better than no liberalisation? And partial opening is superior to protectionism.

*Any evaluation would suggest that PTAs have the following advantages:*

- PTAs are one form of trade agreements and beneficial in optimising comparative advantages.
- PTAs are politically more feasible and can be implemented without excessive opposition from the domestic manufacturers.
- They enhance the size of the market, improve externalities with consequent

improvement in efficiency and productivity which are irreversible.

- They result in greater flow of direct foreign investment among the member States. They improve the level of confidence between contracting authorities allaying in some cases subsisting security concerns. Enhanced trade and economic inter-dependence is an important ingredient of Confidence Building Measure.
- Finally, they create a framework for expanding the size of the preferential trade and eventual merger within a multi-lateral framework.

*In contrast the negatives are equally compelling:*

- Empirical evidence suggests the PTAs have not created the same kind of productivity increases as multi-lateral arrangements; they distort trade patterns between members and non-members building on incentives for inefficient specialisation.
- The additional production encouraged by PTAs may not be internationally competitive at current prices; the arrangement might result in existing industry becoming less competitive — national welfare gains from even country-driven reforms may be greater than improved market access and thus become an inefficient way to transfer income to the poor.
- Investments which become irreversible commit countries to trading with each other and create inefficient structures which may not subsequently withstand global competition.
- The alliance between PTA countries could create stronger protectionist lobbies which may be more difficult to dismantle; these protectionist groups may become politically more formidable. By locking a country into an inefficient production pattern, it handicaps its ability to adjust to a structure that would be more competitive under global free trade. A country is better off joining a PTA where its position relative to other members is similar to its comparative advantage to the rest of the world and so specialisation is similar to what would occur in general trade.

So what does this mean from India's point of view. Given our tariff structure, which is relatively higher than all countries in the region, trade advantages for us, per se, are not particularly attractive. However, if such preferential arrangements become part of a larger economic package which covers investment, services, freer movement of skilled manpower, it would make an assessment more complex. These agreements should then be considered not so much in terms of how much trade liberalisation they bring or how to value this liberalisation relative to multi-lateral trade liberalisation but rather in terms of the benefits of larger investments, technical cooperation, immigration agreements and their multiplier effect. Our high GDP growth and a rapidly growing middle-class with rising incomes, both in urban and rural sector for white and brown goods, is a strong incentive to other countries in seeking a slice from this expanding market.

Nonetheless, from India's point of view, preferential trade arrangements cannot be a substitute for multi-lateral trade liberalisation. We cannot promote arrangements for nations to get embedded in what Anne Kruger describes as the "spaghetti bowl of mutually inconsistent trade restrictions". Hopefully these agreements would

induce our faster alignment to average peak and applied ASEAN rates.

Such arrangements must be evaluated in terms of encouraging much greater investment flows, improving labour productivity and skills in sectors where our comparative factor advantage remains unrealised. Their long-term value lie in spurring faster overall policy changes and adoption of best international practice on fiscal policy, tax regimes, labour laws, treatment of foreign investment and environmental regulations to name a few. Only then can PTAs become a “building block” and not a “stumbling block” for faster development process.

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