Economics & Strategy

DBS Focus

RCEP & India: Weighing the benefits of regionalism

Economics/Growth/Trade/India

Group Research

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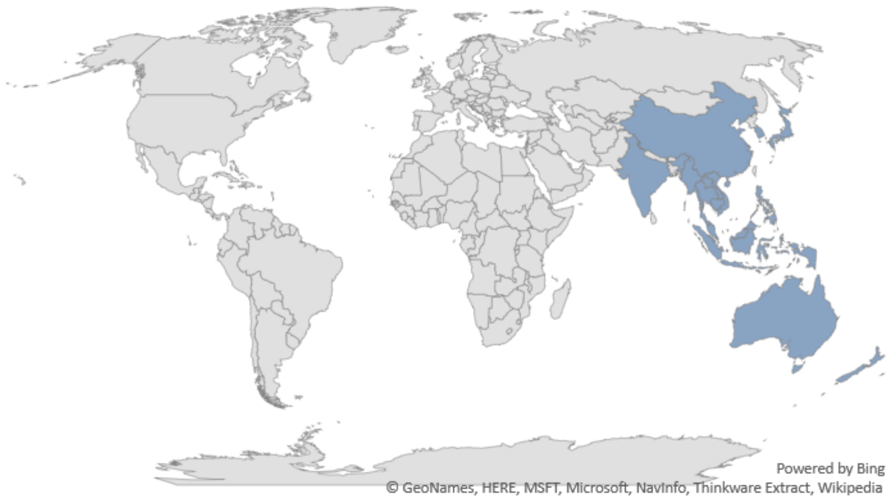
Radhika Rao
Economist
radhikarao@dbs.com

Please direct distribution queries to
Violet Lee +65 68785281
violetleeyh@dbs.com

- *Could India join the Regional Comprehensive Economic Partnership (RCEP)?*
- *Details are still being worked on, as members seek to lower tariff and non-tariffs*
- *India has, understandably, expressed reservations*
- *Hesitation stems from a) limited material improvement in trade in the past post-FTA trends; b) certain stickling clauses*
- *It will, nonetheless, be beneficial for India to continue negotiations to find common ground and seek to join the regional supply chain*
- *A workable solution might be a partnership, with some concessions, a phased integration and stricter rules of origin*
- *The economy is well-placed to benefit from any trade diversion opportunities, short-and long-term*

Countries under the RCEP framework



Ongoing discussions on the Regional Comprehensive Economic Partnership (RCEP) include the ASEAN10 bloc (Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand, Vietnam) together with its six FTA partners - India, China, Japan, South Korea, Australia, and New Zealand. Since the US withdrew from the Trans-Pacific Partnership (TPP) agreement in 2017, the Asia

Pacific bloc has been keen to expedite the RCEP as a viable alternative for global trade with lower trade barriers. Plans were conceptualized in 2012 and found a renewed vigour in the past two years.

While comparisons are being drawn with the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), the coverage and ambitions differ. Besides a different set of member countries covered under the two, both push for tariff liberalisation, but extent of cuts proposed by RCEP is less rigorous, according to the EIU. The other difference is that the RCEP, unlike the CPTPP, is not seeking to harmonise environmental regulatory standards or labour markets. The RCEP has 20 chapters (of which seven are still to be concluded), compared with 30 under the CPTPP.

Push and pull factors to join the RCEP

With trade conflicts and protectionist policies dominating the narrative, multilateral free trade agreements reinforce benefits from a wider market access and enjoy preferential or lower trade barriers. Cumulatively, the bloc accounts for a third of the world GDP, half the world's population, a quarter of world trade and nominal GDP surpassing the US.

Touted as being the largest FTA in the world, this bloc could act as a supplier as well as destination for intra-regional trade, an opportunity to shift from being a 'factory of the world' to 'a market to the world'. Considering US' hardline approach against multilateralism, we concur with the writer in Peterson Institute for International Economics that "there is no alternative to Asian leadership in today's geopolitical environment. But the region has solid credentials for this role: great economic energy, the power of large markets and despite its diversity, a historic commitment to open development models".

Once completed, the agreement is expected to lower trade and non-tariff hurdles, liberalize service trade, ease part of regulatory hurdles in regional trade and improve investor protection, amongst others.

There are also push factors. Better market access to other countries could help offset slowing domestic growth, just as the trade environment gets more challenging. This will a window to deploy excess domestic capacity, improve resource utilization and provide a leg-up for the exporting community.

Negotiations are ongoing, terms and progress of which have been kept in secrecy. Over 25 rounds have been held till date, with plans to conclude deliberations and finalise the ambitious deal by end-2019. A consensus has been arrived on a few aspects, pending on the others – matters related to trade remedies, services, competition, labour movements, investment, e-commerce and product origins are still to be completed. While the RCEP does not target elimination of all tariffs on goods, plans are to lower barriers on at least 90% of tradable goods, spread across the next decade, according to the EIU. Trade ministers are due to meet in Bangkok on October 10-12, with plans to conclude negotiations by the ASEAN summit meeting in November.

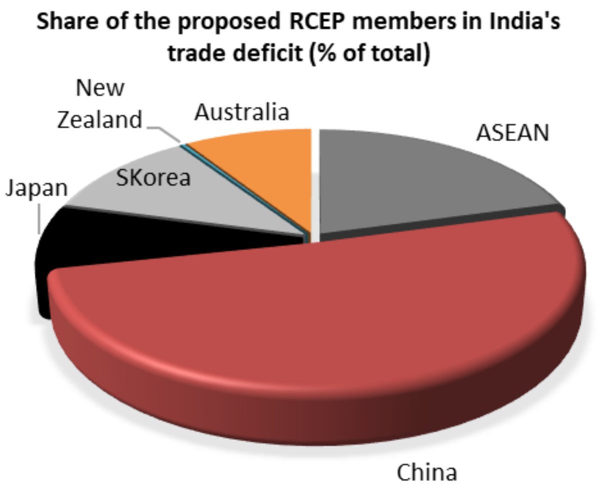
India's negotiating position has emerged as a challenge, particularly due to its stance that it has witnessed limited benefits from prior trade agreements. Authorities have been relatively active in establishing bilateral agreements in the past, nonetheless, following prolonged deliberations and exemptions sought for selected sectors, seeking deeper foothold for its more competitive service exports and counter-clauses to differentiate between countries on grounds of economic strengths and stage of development.

India's concerns

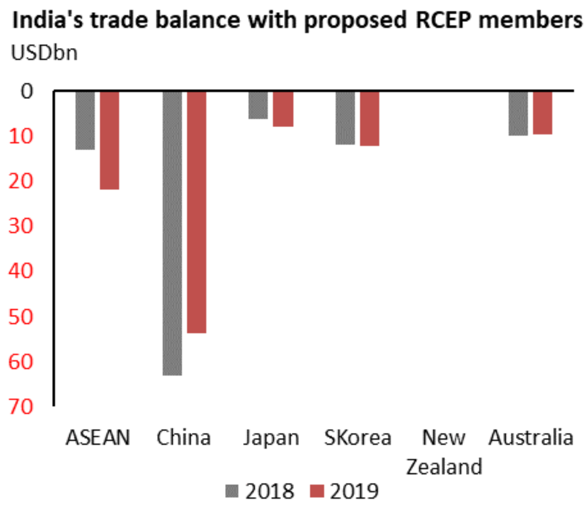
Reticence to participate in trade agreements on a broader note has been on three grounds: a) For RCEP, India already runs a trade deficit with all the member countries. China single-handedly makes up ~60% of the total; b) previous FTAs have not materially improved India's trade math; c) certain unfavourable provisions have turned to be stickling points.

A) **India has bilateral trade agreements with most but not all the proposed members of the RCEP.** Deals have been signed and are in effect with the ASEAN countries, Japan, and South Korea, whilst negotiations are ongoing with Australia and New Zealand. With China, a five-year program for economic and trade cooperation was initiated in 2014, according to the Commerce Ministry, with limited progress on a trade agreement since.

   India runs a trade deficit with most of the member countries, barring smaller trading partners like Laos, Cambodia, Myanmar and Philippines (in FY19). China single-handedly accounts for 60% of the total deficit (see chart below), pointing to already adverse terms of trade. Clearly this sets the math on the wrong footing, as a move to swiftly lower tariffs could aggravate this situation and worsen India's external balances.



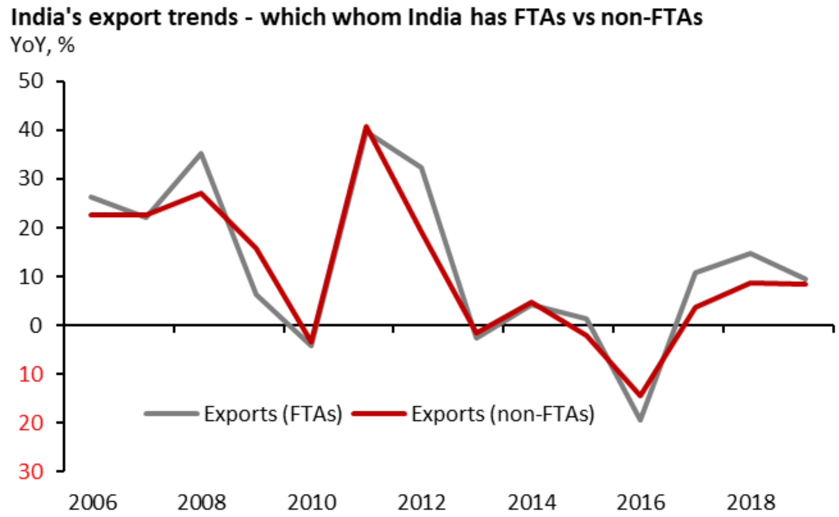
Source: CEIC, data transformation by DBS group research



Source: CEIC, DBS

B) **Undoubtedly, total trade with countries with whom India has FTAs has improved in the past decade.** This has, however, not materially improved India's trade position, as higher exports have coincided with higher imports, worsening the net balance.

Breaking down India's trade into countries with which it has FTAs and the rest referred to as non-FTAs, carries a few observations. Firstly, at the aggregate level, exports to FTA countries have largely mirrored total and non-FTA export growth (see chart below), not exhibiting significant outperformance as one would have expected. This doesn't vary even with exports compounded annual growth rates (CAGR), since 2006. Imports CAGR, however, is marginally higher for FTA than overall and non-FTA economies, suggesting asymmetrical influence on trade trends. A similar picture emerges when balances are considered. Even if we assume a narrower control group (Japan, South Korea and ASEAN), India's deficits with this bloc has widened considerably since around FY10-FY11. Any improvement in exports during this period, thereby, can be attributed to product and destination diversification rather than trade agreements [3].



Source: CEIC, DBS

Next, as the Economic Survey 2016-17 points out, tariffs rates have been falling broadly over the past few years, regardless of whether we consider pre-FTA or post-FTA periods, keeping with the broader shift towards liberalization and stronger global integration. Amongst the countries with which India has signed FTAs, the scale of reduction has been higher in imports than exports, with the ASEAN FTA witnessing the largest decline, as shown in the table below. This has left the net impact as lop-sided.

Table: Average tariffs (post and pre FTAs)

	Pre-FTA		Post-FTA	
Non FTA countries	8.5%		7.7%	
FTA countries	8.6%		5.5%	
Amongst FTA -	Exports		Imports	
ASEAN	6.1%	4.0%	11.3%	4.7%
Japan	3.3%	3.5%	11.4%	7.5%
Korea	9.0%	6.0%	11.1%	8.3%

Source: Economic Survey, DBS

Finally, local press has also cited opposition by specific sectors which are more vulnerable to high external competition, including dairy products, steel industry which is already facing a slump in demand, agricultural sector, garments and textiles, metals, amongst others.

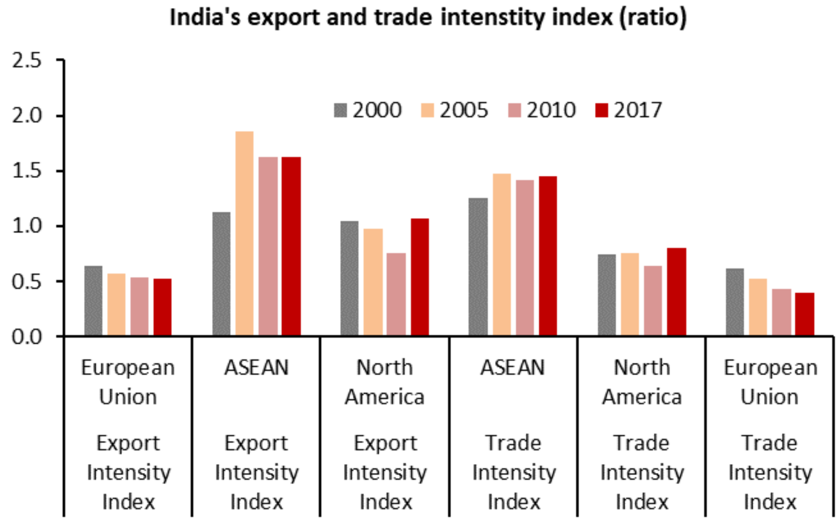
C) **Few other areas of contention in the RCEP include** a) India's suggestion for an auto-trigger mechanism as a safeguard measure, under which levies can kick in once imports cross a certain threshold; b) proposed inclusion of the controversial investor-state dispute settlement (ISDS) in the pact by members like Japan and Singapore (India does not wish for its domestic laws to be challenged by international tribunals), c) strict rules of origin (ROO) clause to stop third country imports (to prevent dumping), d) better offers in services and extend protection to a number of sensitive dairy and farm items and industrial goods.

Of these, we reckon that c) will be critical considering that a buy-in from India might involve substantial reduction in tariffs towards ASEAN at the first stage, before to the rest of the bloc (especially China). India has reportedly emphasized on COO accorded to the country where the highest value addition has occurred, with use of indigenous products. With much of the intermediate/ raw materials (electronics and otherwise) routed through these markets, it will be an uphill task to pinpoint the actual source and origin of the product, thus negating some of the purported safeguards.

Negotiations are ongoing, challenges but benefits aplenty

While being a part of the RCEP carries challenges but it will also open India and rest of the proposed members to numerous opportunities. The early phase of adjustment will be an uphill task as few import tariffs will have to be dismantled, leading to higher competition from imports and in turn hurting export competitiveness. Opportunity cost of non-participation is significant as multilateral trade agreements will help improve India's integration to the global supply chains and market access opportunities.

As shown in the chart below [5], India's trade and export intensity varies across its major trading partners, with ratios vs ASEAN higher than the US and EU. An index of more than one indicates that trade flow between countries/regions is larger than expected given their importance in world trade. These ties have notably strengthened post 2010 after trade agreements were finalized. Nonetheless, when compared to other economies namely Japan, South Korea, Australia, China etc., their intensity ratios with ASEAN is higher than with India, pointing to deeper trade ties and integration, leaving ground for India to catch-up.



Source: ADB, DBS

Not all of India's past trade underperformance is due to trade agreements. Part of the inability to tap trade opportunities have also been due to inefficiencies (cost, productivity, logistics etc.), which has that hurt competitiveness. This is also demonstrated by the inability of exports to gain ground despite a weakening currency during the past decade. By contrast, India has fared well on the service exports front, running a surplus with key trading partners.

Press reports [6] suggests that India's market access negotiations with China are still to be concluded ahead of the Bangkok session (Oct 10-12). India has reportedly agreed to remove duties on 74% of its traded goods with China over the next two decades (and potentially increase to 80%), for a concurrent reduction in China's tariffs.

A workable solution for India to participate in the RCEP might be a partnership, with some concessions and a phased integration. This might entail a wider exclusion list of products to begin with, tariffs on which could be removed or lowered at a gradual pace and on pre-decided timeline. This will help to gain industry buy-in and provide time for domestic manufacturers to adjust to the upcoming increase in competition for imports and exports. Secondly, adherence to strict country of origin rules is likely to be prioritized. Finally, a special mechanism of tariff and non-tariffs coupled with pre-specified technical/ sectoral assessment systems specifically with China will be important to allay fears over lop-sided impact following the trade agreement. **If this window is tapped, India will be in a position to gradually benefit from trade diversion opportunities, with the recent**

cut in corporate taxes and improving position in the Ease of doing business index plus FDI restrictiveness index to carry short-and long-term (see here) benefits, against the backdrop of protectionist global opportunities.

Notes:

[1] RSIS; RCEP – Another missed deadline; November 2018

[2] OpEd by Peter A. Petri (PIIE) and Michael G. Plummer (Johns Hopkins University and East-West Center)

[3] Niti Aayog paper; "A Note on Free Trade Agreements and their costs"

[4] Economic Survey 2016-17

[5] Asian Development Bank, AIC database; Asian Journal of International Law 9, authored by Chakraborty, Chaisse, Qian (2019)

[6] https://www.livemint.com/politics/policy/india-grapples-with-ways-to-deal-with-china-in-rcep-11570383135404.html

Group Research

Economics & Macro Strategy

Taimur Baig, Ph.D.
Chief Economist - G3 & Asia
+65 6878-9548 taimurbaig@dbs.com

Chang Wei Liang
Strategist
+65 6878-2072 weiliangchang@dbs.com

Nathan Chow
Strategist - China & Hong Kong
+852 3668-5693 nathanchow@dbs.com

Masyita Crystallin, Ph.D.
Economist – Indonesia & Philippines
+62 21-2988-4003 masyita@dbs.com

Joanne Goh
Regional equity strategist
+65 6878-5233 joannegohsc@dbs.com

Eugene Leow
Rates Strategist - G3 & Asia
+65 6878-2842 eugeneleow@dbs.com

Chris Leung
Economist - China & Hong Kong
+852 3668-5694 chrisleung@dbs.com

Ma Tieying, CFA
Economist - Japan, South Korea, & Taiwan
+65 6878-2408 matieying@dbs.com

Radhika Rao
Economist – Eurozone, India, & Thailand
+65 6878-5282 radhikarao@dbs.com

Irvin Seah
Economist - Singapore, Malaysia, & Vietnam
+65 6878-6727 irvinseah@dbs.com

Samuel Tse
Economist - China & Hong Kong
+852 3668-5694 samueltse@dbs.com

Duncan Tan
FX and Rates Strategist - Asean
+65 6878-2140 duncantan@dbs.com

Philip Wee
FX Strategist - G3 & Asia
+65 6878-4033 philipwee@dbs.com

Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).