A Stronger European Union: Implications for India

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His excellency Ambassador (of EU to India) Michel Caillouet,

Dr. Kant Singh,

Ladies and Gentlemen,

I am truly delighted to be here this afternoon. At the outset I would like to convey my gratitude to the Council of EU Chambers of Commerce in India for providing me an opportunity to share my thoughts with this august gathering on an issue of great contemporary relevance.

Let me start by commending all of you - ladies and gentlemen - from the Council of EU Chambers of Commerce in India, for having played an exceedingly useful role in furthering the economic ties between India and the EU over the last 21 years.

Before proceeding further, let me clarify that I am not here to represent the RBI or the Government of India. Views that I shall express this afternoon are my own and should not be treated as the official position.

Friends, as we all know, the European Union (EU) is gearing up for the biggest enlargement ever, both in terms of scope and diversity. This is both an opportunity as well as a challenge for the EU to foster

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the integration of the Continent and thereby extend stability and prosperity to the new members. At present thirteen countries have applied to become new members: ten from Central and Eastern Europe (viz. Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic, and Slovenia) and three Mediterranean countries (*viz*. Cyprus, Malta, and Turkey). Of these countries, I believe all except Bulgaria, Romania and Turkey have been permitted to join the EU in 2004.

Even in its present composition of 15 member states, the EU is already a global actor in the international arena and it is anyone's guess how influential it would become at least in the medium term once its enlargement takes effect next year. In its capacious size, the single largest market and a single currency, with further enlargement, the Union would of course, be even bigger economic force to reckon with.

A question close to my heart - and I am sure, relevant for many of you is what will be the implications of the enlargement of EU for the Indian economy? Friends, that is precisely what I will propose to focus this afternoon.

Like all deep-rooted relationships, the Indo-EU relationship is also multidimensional, covering spheres such as political, strategic, humanitarian, and most importantly the economic issues. The purview of my deliberation today, however, is essentially economic relationship between India and the European Union, in the specific context of international strengthening and broadening of the EU. Even within this area, I would like to deal mainly with trade and investment related issues.

Being the largest trading partner and second largest source of foreign direct investment, the European Union (EU) is one of the important economic partner as far as India is concerned. At the same time, being the fourth largest economy (in PPP terms) and one of the fastest growing economies of the world over the decade or so, as also being producer of the largest pool of technically skilled manpower, India certainly offers an attractive option to the EU for building a durable and prosperous economic partnership. The growing levels of trade and investment flows between India and the EU bear testimony to the fact that we are on the right course and are doing reasonably well.

Recognising the importance of Indo-EU relations and the need to strengthen it, between 1973 and 1994, three bilateral agreements have been signed. Three annual summits have been held since the historic Indo-EU summit of 2000 in Lisbon. There are numerous joint initiatives between India and the EU to enhance scope of relationship in specific areas. Notwithstanding the important progress made to enhance cooperation through such dialogue and initiatives, I am sure - and I hope all of you would agree with me, that there are several areas where our partnership has much bigger potential than what has been achieved so far. This, coupled with the current drive of the Union towards increased internal strengthening, better cohesion and harmonisation and the roadmap for future widening, the scope for increased economic interaction between India and the EU is enhanced further.

What are the specific issues that are crucial in furthering our trade and investment relations with the EU? I would like to take this opportunity to flag the contentious issues so that with our collective wisdom, endeavour and experience, we can find effective ways to circumvent or at least lessen the constraints posed by issues. I am convinced that an open mind and a pragmatic approach on these issues, from both sides, can immensely boost our economic ties.

There are two sets of issues - the existing ones and - the emerging ones.

A. Existing Issues

1. Asymmetry in India-EU relations

The biggest asymmetry in Indo-EU relation is the relative economic importance of these two partners for each other. Nearly 20 percent of India's foreign trade is transacted with the EU and about 15 percent of our foreign investment inflows are sourced from the EU. In contrast, India accounts for only slightly above 1 percent of the total foreign trade in goods with the EU and less than a percent each of trade in services and total outward foreign investment from the EU. This is highly assymetrical to say the least.

Another related issue is the trade creating effect of formation of the Union net of its trade diverting effect. Trade creation effect following the formation of trade block, in this case the Union, refers to the increase in imports by the Union from non-Union countries as a result of say, increased prosperity or specialisation within the Union. Trade diversion effect, on the other hand, refers to a situation when, with the removal of barriers within the Union, more efficient sources of import from non-Union countries get replaced by less efficient producers within the Union. There are empirical findings which indicate that the overall effect of the formation of the Union on world trade has generally been positive. That is, trade creating effect generally surpasses the trade diversion effect. This positive effect is particularly noticeable as far as emerging market economies of Asia are concerned. I am, however, extremely disappointed to share with you that, while the net trade creating effect of formation of the Union is also positive for India, our share is miniscule in the global net trade creating effect of the Union. Clearly, compared to many of our Asian neighbours, India is in a relatively disadvantageous position in sharing the prosperities emanating from a stronger Union.

Delegates from the EU have often pointed out the structural problems of doing business with India in terms of procedural hurdles, bureaucratic delays, slow pace of reforms, higher tariff levels, lack of transparency, sectoral caps on foreign investment and so on. I would like to point out that gradualism rather than big bang in the economic reform process is a deliberate choice rather than a *fait accompli* for India. This, in a sense, is reflective of the plurilateral and consensus-based decision-making process in India. The process involves endeavours for broad consensus building in large democratic country with complex political and economic configurations. It is also important to note that chances of policy reversals are much less under an economic reform process if the country adopts a sequenced gradual approach as opposed to a shock therapy.

In this regard, one issue, which is of particular interest to foreign investors is the credit rating of the country. It, however, beats me to understand how India:

with a democratic and stable polity in almost the entire post-Independence period,

without any blemish of default,

armed with nearly US $ 85 billion worth of foreign exchange reserves, posting strong growth performance year after year and relatively benign inflationary situation over at least a decade.

with full capital account convertibility for non-residents,

- can have a below investment grade credit rating!

I would like to draw the attention of rating analysts for the need to incorporate serial defaults by sovereigns while arriving at country ratings. I would also urge entrepreneurs and businesspersons from EU to look beyond the landscape of international credit ratings and instead see for themselves the metamorphic changes taking place in India.

2. Policies in EU constraining an active Indo-EU relationship

When one looks at the Indo-EU trade and investment regime from the Indian side, Indian exporters to EU come up with various complains and grievances relating to procedural aspects and treatment of Indian exports in EU especially those relating to steel, textiles and clothing and agriculture.

Steel Industry: Though steel, in more sense than one, symbolises the very foundation of the Union, there are views that the stance of the Union on international trade in steel has a protectionist bias. It is a trifle ironical that while manufacturing of steel is equated with a country's level of industrialisation, many industrialised countries have significant barriers to insulate their relatively inefficient domestic steel industry from competition emanating from emerging market economies. The steel industry has achieved the dubious distinction of being the sector where the incidence in application of anti-dumping duties is one of the highest. India has a vibrant iron and steel industry, which, it has been claimed, is getting adversely impacted by the protectionist policies of the industrialised countries including the Union.

Textiles: In the context of phasing out of multi-fibre arrangement (MFA), the bi-lateral quota-based agreement has governed a major part of international trade in textiles and clothing since the 1970s. Many Indian exporters feel that the pace of liberalisation in the Union has been extremely slow, especially with respect to products where developing countries like India has a major trade interest. It has been argued that the agreement on textiles and clothing under the aegis of the WTO has various ambiguities. Taking advantages of these, many industrialised countries in the Union along with the United States, seem to be deploying tactics in the phasing out process of MFA. In addition, it has been pointed out that expansion of market access in the EU is the slowest for the group of textile and clothing items known as "other bilateral agreement" (OBA) items. India has a major export interest in OBA items. Therefore, it has been argued that India is one of the worst affected trade partners of the EU as far as trade in textiles and clothing is concerned. There are also claims that in certain regions of the EU, additional technical barriers are being imposed on Indian textile and clothing products in the form of stringent technical standard requirements not commensurate with the price and functional use of such items.

Agriculture: Another sector where liberal policies if adopted by the EU can have far reaching implications for trade by developing countries is agriculture – the oldest occupation of mankind. Indian agro-exporters claim that protectionist agricultural policies pursued by the EU restrict their market access in the Union. Furthermore, the subsidised exports from the Union also erode their competitiveness in third-country markets. The methodology that has been followed by the EU to work out the equivalent tariff protection for agricultural products in lieu of removing the WTO-inconsistent non-tariff barriers has been questioned by some of the leading trade specialists from all over the world.

In this context I would like to draw your attention to an interesting point that emerged during interaction between EU Trade Commissioner, Mr. Pascal Lamy and a group of Indian entrepreneurs. An Indian liquor manufacturer complained to Mr. Lamy that due to non-tariff barriers in the EU, it is not possible to get market access in the Union. Mr. Lamy answered, (I quote), “Alcohol derived from molasses is not considered as whiskey in the EU. … EU sees Indian whisky as rum. We have certain tariff protections for domestic manufacturers of rum. That is why Indian whisky is not able to gain market access in the EU” (unquote). In contrast, many of you might have had the chance to glance at the French and Italian wines in the shelves of our wine stores in recent years. Rather than any academic debate, I am sure that most of us would prefer to let our taste buds give a final judgement on what is rum and what is whisky.

Last week, EU and USA arrived at a broad consensus on their negotiating strategy at the WTO in the context of trade in agricultural products. The basic focus of the strategy is to introduce sharp reduction in tariff relating to agro-products while effecting no major reduction in both domestic and export subsidies provided to agricultural products. Any keen observer of multilateral trade negotiations would consider this as an extremely clever maneuver by EU and US on a crucial issue on which they have been at the loggerhead for a long time. This is a win-win situation for both the concerned economies. The high level of farm subsidies in the Union would now have the blessings of the US whereby US would no longer use the strong lobby of agricultural product exporting countries, Crains, to brickbat the EU on its protectionist farm trade policies. In return, the US gets a better market access in the EU due to lower tariff on farm products. This is great, as far as it goes. However, trade specialists feel that it goes not get too far. With US-EU on one side and rest-of-the-world on the other, this is being seen as a two-person zero-sum game. That is, the gain of EU-US would be the loss of rest-of-the-world. In fact, apprehensions are that the loss of rest-of-the-world would by far surpass the gain of US-EU.

A lowering of tariffs on agro products by the EU would lead to larger market access for US in the Union for such products, especially temperate zone agro-products. This would take care of the biggest apprehensions of the US on the agro policies of the EU. This, however, would not address the main problem of most of the developing countries (including India) having sizable agro-exports. For these countries, the unequal competition posed by subsidised tropical agro exports from EU in the third country markets is a big concern. Added to that, domestic subsidies to TROPICAL agricultural products in the EU rather than tariff rates are major concerns of the developing country agro-exporters as far as market access in the EU is concerned.

5. Non-trade Issues

A major area where India and the Union have agreed to disagree relates to what is known in India as non-trade concerns at the WTO. This cover issues relating to labour standards, international investment norms, competition policy, trade facilitation, etc. The official Indian view is that these are extremely important issues and most of them need international consensus building. We feel that the link between these issues and international trade are at best extremely remote. Therefore, WTO may not be the appropriate forum to address these issues. For example, the International Labour Organisation rather than the WTO is the appropriate agency to deal with labour standard related issues. In fact, there is a growing literature that suggests that linking some of the "non-trade concerns" with international trade may in fact lead to sharp worsening of the very conditions that these concerns try to improve upon. The official stance of the EU is very different from India on these issues. The Doha Work Programme has called for a consensus building on many of these issues before their inclusion within the purview of the WTO. I am hopeful that during the Cancun Ministerial, positive steps would be initiated to resolve the problems faced by developing country exporters due to arbitrary use of sanitary and phyto-sanitary (SPS) requirements.

I do not want to take a categorical stance on these issues mostly because the issues involved are extremely complex and therefore no dogmatic approach can aid us to reach a consensus. Only a more open and accommodative approach can get us out of this impasse. I would like to reiterate the merits of greater flexibility and unorthodox approach on the part of both India and EU on these issues. This would not only benefit us to narrow down our differences, but would also enable us to work more closely at the WTO on issues where our stances are already synchronous such as policies to promote rural development, preferential market access for developing countries, codification of special and differential extended by the WTO to developing countries, protection of geographic indicators, and so on.

B New Concerns

I would now turn to the new concerns voiced in India in the context of widening of the Union by inducting new members.

1. India's trade with EU Candidates

Trade Volumes: In the 1980s, India had significant trade relations with some of the east European countries, which are now slated to join the EU in 2004. With the collapse of the eastern bloc and bilateral rupee trade arrangements between India and certain east European countries, India's trade volume with these countries declined sharply since late-1980s. A close look at the Indian trade data reveals that of the ten candidate countries, India's main trading partners are - Poland, Hungary, Slovenia and the Czech Republic. As of now, though the trade volumes between India and east European countries are not very high in absolute terms, in recent times such flows have grown at very high pace.

Benefit of Lower Customs Tariff

India's major exports to these countries include primarily agricultural products and textiles and clothing. On accession to the EU, these east European countries would adopt the common trade policy – both tariff and non-tariff protections – as being followed by the EU. Thus, an advantage accruing to third countries like India from the accession will be lower Common Customs Tariff (CCT) that the exporters from India would enjoy. Certainly on annual average basis, the level of tariff protection currently being applied by east European countries are much higher than the average level of 4 percent being followed by the EU. However, as far as trade in agricultural products and textiles and clothing is concerned, such a generalisation is not possible.

Textiles: In the context of trade in textiles and clothing, east European countries were not a part of MFA but they would be on accession. Though MFA is slated to be phased out by the end of 2004, the tariff protections, which would replace the protection through bilateral quota, would in many cases be substantially higher than the average tariff level of the EU or those being currently applied by the east European countries on such imports. Many Indian exporters feel that impediments to India's trade with acceding east European countries would increase after 2004 and as a result, there regrettably is a possibility in the reduction of trade flows between India and these countries.

Trade Diversion Effects: Perhaps a more fundamental apprehension of the widening of the EU comes from the possible trade diversion effect emanating from the process. Any observer of international trade would vouch that in general south-south (intra-developing country) trade is much smaller than north-south (between industrialised and developing countries) trade. Under the present composition of the EU, most of the countries are advanced industrialised countries, which had a historically high level of synergy even before the unification. The economic characteristics of the new entrants to the EU would, however, be significantly different. With the lifting of trade barriers between the old and new members of the EU, there may be considerable trade diversion. Trade creation through say increased income and specialisation in this case is likely to take place only in the longer run. Therefore, at least in the foreseeable future net trade diversion effect may be more dominant. Under such a scenario, it may be difficult for India even to maintain her already meager share in the total imports of the EU. This is especially true given the large overlaps in India's export basket to the EU and production structure of the countries slated to join the Union.

Compensation Mechanism: There are sharp differences in economic structure of the present and prospective members of the EU. However, as per the constitution of the EU, once the prospective members join the Union, they have to abide by the common commercial policy of the Union. Against this background, some feel that there is a possibility that the EU might renegotiate its bound tariff levels at the WTO with respect to certain tariff lines. Though the WTO has mechanism for compensation for members adversely affected by renegotiation by another member, actually getting such compensations can be yet another issue. There is a wide consensus that the dispute settlement mechanism instituted under the WTO is advantageous for developing countries as compared to the redressal mechanism that existed before the establishment of the WTO. Nevertheless, many observers of the WTO feel that the mechanism may have a bias in favour of countries with larger trading volumes. Therefore, if countries like India get adversely affected by tariff renegotiations by the EU, getting adequate compensations under the WTO framework, even through the dispute settlement mechanism, is neither automatic nor is a certainty.

2. Investment Flows from Candidate EU

Investment Level: On the investment side, during 1991-2002, FDI approved by India from these countries amounted to only US $ 83.17 million. Which though low, may be expected to increase in the near future in the wake of attempts being undertaken in WTO etc. to strengthen the international investment regime. On the other hand, the widening of the EU may also adversely impact the inflows of capital from the Union to India. Accession of a large number of east European economies in the EU would certainly increase the attractiveness of investment in these territories especially for international investors from the current member states of the EU. Reduction of information asymmetry after the unification, larger commonality in terms of macroeconomic policy stances and regulatory policies, greater ease of contract enforcement, etc. are likely to tilt the balance in favour of the new members of the EU. The resultant situation would give rise to capital flow equivalent of trade diversion effect.

III. Concluding Remarks

Before I conclude, let me say that while I have discussed some of the contentious areas in Indo-EU trade and investment relations – current and future – it does not in any way undermine what has been achieved through our enhanced cooperation. The problems and apprehensions that I have touched upon are impediments in furthering our relations. Therefore, rather than trying to sweep them under the carpet or taking them as given, we should resolve them through dialogue and affirmative action. Here again, I feel that with enhanced pragmatism and non-conventional approaches on the part of both, constraints imposed by most of these problems can at least be lessened significantly. We have to strive towards such a scenario. We have to create a win-win situation by fully utilising the great potentials for cooperation, which exist between the Union and India.

Areas for Cooperation: Already four major areas namely power and energy, biotechnology, financial services and textiles and clothing have been identified as areas where India and EU may enhance their cooperation. In more than one sense, India and the EU have certain complementarity in these areas. Our joint initiative here, I am sure, would be extremely fruitful. Under Indo-EU joint initiatives, background papers and joint recommendations have already been framed in all of these four areas. We should now jointly try to implement these.

Being two important regions of the world, it becomes incumbent on us to share the responsibility of making the global economic order just and equitable one. In this respect, we need to enhance the level of cooperation with one another and explore more and more of the complementarities between us to deepen our relations. Mr. *Benedetto Amari* (Ambassador of Italy to India) in one of the Indo-EU seminar rightly said, "India's relations with EU was a two-way street and it is the levels of awareness and comfort, which need to be raised to facilitate both sides into a stronger post-enlargement relationship". It is hoped that the fourth Indo-EU summit to be held in New Delhi in November 2003 would further this Indo-EU relationship. We welcome EU's enlargement and we have common interest in the capitalising on the opportunities and face the challenges arising subsequent to the EU's enlargement.

I extend my most sincere wishes for a healthy and prosperous future for the stronger Union and a widening and deepening of the relationship of the Union and India.

Thank you.