

RIS

DISCUSSION PAPERS

**A Road to Common Prosperity –
Examination of
An FTA between India and China**

Li Wei

RIS-DP # 49/2003



**Research and Information System
for the Non-Aligned and
Other Developing Countries**

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RIS Discussion Papers intend to disseminate preliminary findings of the research carried out at the institute to attract comments. The feedback and comments may be directed to the authors(s).

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A Road to Common Prosperity -- Examination of An FTA between India and China

I. Review and Prospect of Regional Economic Cooperation in Asia

During the 1990s, the accelerated economic globalization and regionalization has aroused widespread concern throughout the world economy. As of October 2002, 255 Regional Trade Arrangements (RTAs) have been notified to the GATT/WTO. Of these, 213 agreements were notified under GATT Article XXIV, of which 131 are still in force today; 20 agreements were notified under the Enabling Cause; and 22 under GATS Article V¹. The WTO-plus Free Trade Agreement (FTA) goes a further step than WTO on the part of market opening extent, hence creates more advantageous conditions for the involving parties to expand mutual trade and investment. It is a successful and effective means of common prosperity and development that has been examined by the experiences of EU and NAFTA, because it leads to closer ties and greater interdependence among involving parties. However, regional cooperation such as FTA is fairly new to Asian economies. Until the 1990s, East Asia had no formal regional trading arrangements, except for ASEAN.

Yet East Asia has quickly responded to regionalization and has witnessed a rapid development. Various forms of regional economic cooperation have been set up. Since 1997, ASEAN Plus Three (China, Japan and Korea, APT or 10+3) Summit Meeting has been held every year. Under the framework of “10+3” Cooperation, there are three ASEAN Plus 1 (10+1) Cooperation Schemes. In addition, one “10+1” cooperation has already led to Free Trade Area. In November 2001, leaders of ASEAN and China decided to establish a Free Trade Area within 10 years. (ASEAN and China signed the Framework Agreement of Economic Cooperation one year later and agreed to establish the world’s most populous FTA by 2010.) The decision has

facilitated Japan and Korea to carry out similar closer economic cooperation with ASEAN. In January 2002, Japan signed with Singapore the Japan-Singapore Economic Partnership Agreement (JSEPA). And Japan and Korea have also launched talks of FTA with ASEAN.

Regionalization is becoming an important dimension of East Asian economies' overall liberalization strategy, and the tendency is likely to be strengthened in the future. Actually, the East Asia Study Group has already talked of transforming the current "10+3" Cooperation into East Asia Free Trade Area.

For political reasons, regional free trade agreement in South Asia has not made much progress. This makes South Asia's largest economy – India shift to East Asia, by proposing to conclude a regional trade and investment treaty or an FTA with ASEAN in the ASEAN-India Summit in 2002. (In fact, the ASEAN-India Summit could also be treated as a "10+1".) It shows that India has also begun to take an active approach in regional economic cooperation. Although India currently only attended in the ASEAN-India Summit, it is quite likely that the current four "10+1" will be evolved into a "10+4" (China, Japan, Korea and India).

It is expected that Asia will witness more bilateral FTAs, and a larger regional trade agreement is also likely to emerge. Bangkok Agreement is another notable regional trade arrangement in Asia that includes six countries, three from East Asia (China, Korea and Laos) and three from South Asia (India, Bangladesh and Sri Lanka). It has special meaning in that it might be a platform to link the East Asia and South Asia into broader regional trade agreement. Except for Bangladesh and Sri Lanka, the other four member of the Bangkok Agreement all have relations with ASEAN: either ASEAN member or the "1" in "10+1". It might be a bold idea to combine the members of Bangkok Agreement and the several "10+1" into a new Pan-Asia Economic Cooperation Circle.

¹ Committee on Regional Trade Agreements, World Trade Organization

It might be even bolder to absorb other SAARC members and the two countries of the Australia-New Zealand Closer Economic Relations Trade Agreement (CER or ANZCERTA) into this Circle. If so, it will include a population of 3 billion, a total GDP of US\$ 7 trillion and a trade volume of US\$ 2.5 trillion. Greater economic scale in regional economic cooperation might yield greater economic benefits to the involving parties. The Pan-Asia Economic Cooperation Circle would provide another important mechanism for shoring up economic stability in Asia and drive the economic growth. The diversified economic structures of these countries will make them highly complementary, because this Circle includes developed countries like Japan, NIEs like Singapore and Korea, and least developed countries like Laos and Cambodia.

The idea might seem remote for political reasons, but it is not impossible because most of these economies are in the process of or intend to participate in regional economic cooperation. No matter how difficult, this is a direction of closer Asian economic cooperation and a means to Asian economic integration. The easier part is to carry out bilateral-level cooperation, and a series of intertwined cooperation might help lead to the overall integration. What should be noted is that all the involving parties must be serious in building an institutionalized RTA or FTA. There is no meaning in building another APEC-like organization in Asia.

Table 1. Free Trade Agreements in East Asia

	Year	Participants and Status
1. FTA in force		
Australia-New Zealand Closer Economic Relations Trade Agreement (CER or ANZCERTA)	1983	Australia, New Zealand
ASEAN Free Trade Area (AFTA)	1992	10 ASEAN members
Singapore-New Zealand Free Trade Agreement	2001	Effective in January
Japan-Singapore Economic Partnership Agreement (JSEPA)	2002	Effective in November
Singapore-EFTA (European Free Trade Association) Free Trade Agreement	2002	Signed in June and effective in January 2003
2. Agreements being negotiated, studied, or considered		
East Asia Free Trade Area (EAFTA)	2000	Proposed at the ASEAN plus Three summit meeting
ASEAN-China Free Trade Area (ACFTA)	2001	Realization by 2010 (Framework Agreement signed in 2002)
Japan-ASEAN Closer Economic Partnership (JACEP)	2002	Realization within 10 years agreed to at an ASEAN-Japan Summit Meeting
ASEAN-India Regional Trade and Investment Agreement	2002	Consideration of an agreement agreed to at the ASEAN-India summit meeting
Bilateral free trade agreements		<p>Singapore: Australia, Canada, Mexico, United States</p> <p>Thailand: Australia, India, Japan</p> <p>China: Hong Kong SAR, Macao SAR</p> <p>Philippines: Japan, US</p> <p>Japan: Mexico, Philippines, Korea, Thailand</p> <p>Korea: Japan, Mexico, Chile</p>

**Table 2: The Scale of the Pan-Asia Economic Cooperation Circle
(ASEAN+Three+SAARC+CER)**

US\$ Billion

	Population (Million)	GDP	Export	Import	Total Trade
ASEAN	435.50	585.49	410.69	345.83	756.52
China	1285.00	1075.61	266.62	243.52	510.14
Japan	127.34	4141.40	403.27	348.90	752.18
Korea	47.34	422.17	116.53	109.29	225.82
India	1017.54	464.60	43.59	49.61	93.21
Sri Lanka	19.10	15.66	4.82	5.91	10.73
Bangladesh	140.37	45.38	4.96	8.39	13.35
Pakistan	144.97	56.07	9.24	10.19	19.43
Bhutan	2.09	0.48	0.12	0.18	0.30
Nepal	23.59	5.45	0.74	1.47	2.21
Maldives	0.28	0.50	0.08	0.40	0.47
Australia	19.49	357.93	63.49	63.94	127.43
New Zealand	3.85	50.47	13.73	13.36	27.10
Total	3266.46	7221.20	1337.88	1201.01	2538.89

II. Establishing an FTA between India and China

While the proposed Pan-Asia Economic Cooperation Circle might still be a long-run ideal, the bilateral economic cooperation might be a starting point for the realization of that dream.

China has made progress in the bilateral cooperation in East Asia. However, its economic and trade cooperation with South Asia seems to be lagged behind. The following part will examine the possibilities of a Free Trade Agreement between India and China.

1. Economic Growth and Trade Expansion

India and China are the most populous countries in the world, and the two largest developing countries in Asia. Currently, China and India are 6th and 13th largest economies in the world. Both of them have enjoyed rapid economic growth during the past decade, and have

advantages in certain industries, but their current trade relation does not conform to their economic status. Although they both are members of the Bangkok Agreement, the bilateral trade has not achieved the deserved development. In 2002, the bilateral trade between India and China increased by 37.6%, much higher than China's overall growth rate of 21.8%. Yet the trade value was only US\$ 4.9 billion. China's trade with India accounted for a meager 0.8% of its total external trade. It's about the same for India.

To achieve a deserved development between the two countries, an FTA is a successful and convenient way. The aim to conclude an FTA is not just to reduce and eliminate their existing tariff and non-tariff barriers. The cooperation should be a comprehensive framework, including market integration, such as investment promotion, trade facilitation and harmonized trade and investment rules and standards. If a complementary mechanism is to be formed through the establishment of the FTA, trade and investment will be enlarged quickly.

Table 3: China's External Trade with India

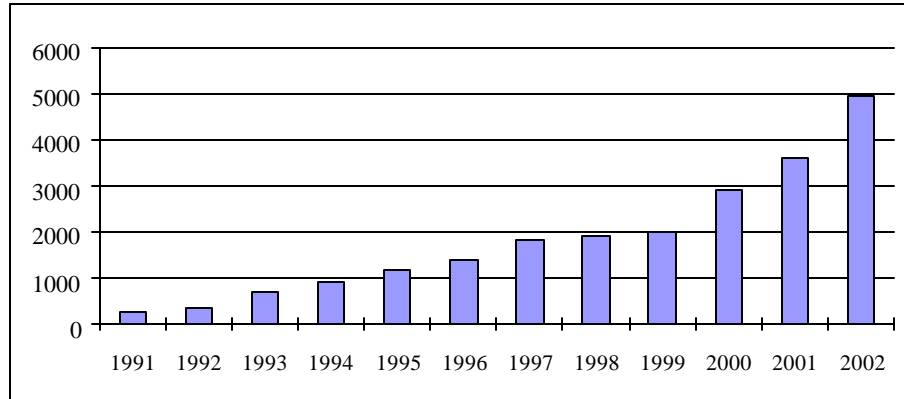
US\$ Million

	Export	Import	Total	Growth rate of total trade %
1991	144.48	120.34	264.82	0.3
1992	158.44	180.99	339.43	28.2
1993	259.16	416.57	675.73	99.1
1994	573.01	321.78	894.79	32.4
1995	765.28	397.53	1162.81	30.0
1996	687.54	719.16	1406.7	21.0
1997	933.06	897.26	1830.32	30.1
1998	1016.6	905.7	1922.3	5.0
1999	1161.89	825.79	1987.68	3.4
2000	1560.75	1353.48	2914.23	46.6
2001	1896.27	1699.97	3596.24	23.4
2002	2671.73	2274.18	4945.91	37.5

Source: China's General Administration of Customs

Chart 1: Total Trade between India and China

US\$ Million



Source: China's General Administration of Customs

Among the Indian exports to China, chemicals, plastics, steel and construction materials have witnessed the most rapid growth. And it is electromechanical products, chemical and durable consumer goods for China's export to India.

The structure of exports to each other did change much from 1997 to 2002, but their exports had diversified. The top six chapters of Indian exports make up only 65.1 per cent of total exports to China, 12.8 percentage points lower than that in 1997. China's exports to India were more diversified. The share of its top six chapters of exports to India decreased from 77.7 per cent to 44.0 per cent. This demonstrated that the two countries' complementary potential had not been fully tapped.

What most people understand about the complementary between the two countries is India's strength in software and China's competitiveness in hardware. As a fact, the mutual trade in this respect has increased fairly rapidly. Based on the trend of bilateral trade and the two parties' economic development, other commodities that India enjoys advantages in the Chinese market in the future are: agricultural products (fruits, vegetables and seafood), plastics, chemical products and auto parts. And China's durable consumer goods, electronic components, silk and manufacturing intermediates have advantages in Indian markets.

Chinese Premier Zhu Rongji, when visited India in January 2002, has proposed to enhance the bilateral trade to US\$ 10 billion. Actually, this goal might not need too much time to realize. According to a preliminary simulation analysis, the India-China trade will expand to US\$ 30 billion even if their tariff rates are reduced to 5% instead of 0% by 2013.

Although no model has been made to evaluate the economic growth after the establishment of an FTA, it is for sure that the two sides will enjoy economic growth. With the trade and investment liberalization and barriers eliminated, and the comprehensive economic and technological cooperation, it will help enhance their production capability, efficiency and product competitiveness, and as a result will create more export opportunities to the world markets.

FTA leads to greater specialization in production based on comparative advantage and this will improve the division of labor. Besides, through specialization under the FTA framework, one member might shift the original expense on one product to others, which might increase the social demand, and hence the trade volume.

With the formation of FTA enterprises in each country must become more efficient to meet the competition of other enterprises within the FTA. The fierce competition will further promote the specialization, and as a result increase productivity and economic welfare. Not only would competition intensify between Indian and Chinese companies, but strategic alliances between them would also be created in many sectors. The survived enterprises might become globally competitive.

Table 4: Structure of India's Export to China

US\$ Million

1997			2002		
Product	Value	Share %	Product	Value	Share %
Ore sand, slag and calx	246.9	27.5	Ore sand, slag and calx	626.1	27.5
Fodder	197.3	22.0	Plastics and products	262.1	11.5
Cotton	178.7	19.9	Organic chemicals	234.8	10.3
Organic chemicals	25.9	2.9	Cotton	156.7	6.9
Hide and leather	25.4	2.8	Jewelry	104.7	4.6
Steel	24.9	2.8	Electromechanical, video-audio equipment and parts	96.3	4.2
Subtotal	699.1	77.9	Subtotal	1480.7	65.1

Source: China's General Administration of Customs

Table 5: Structure of China's Export to India

US\$ Million

1997			2002		
Product	Value	Share %	Product	Value	Share %
Organic chemicals	208.1	22.3	Organic chemicals	543.3	20.3
Mineral fuels and oil	176.2	18.9	Natural silk	219.5	8.2
Electromechanical, video-audio equipment and parts	152.9	16.4	Mineral fuels and oil	189.1	7.1
Natural silk	80.2	8.6	Optical, photographing and medical equipment	82.7	3.1
Inorganic chemicals	62.7	6.7	Electromechanical, video-audio equipment and parts	76.4	2.9
Steel products	45.0	4.8	Chemical fiber	65.2	2.4
Subtotal	725.1	77.7	Subtotal	1176.2	44.0

Source: China's General Administration of Customs

The tariff rate in India is a little bit higher than that of China's. It is reported that India's tariff rate is about to be reduced to 17-18% late this year from the present 26%. China's average tariff rate is only 12%. In this context, with the gradual reduction of tariff rate, measures of trade facilitation should also need to be implemented. It is estimated by the World Bank, that if all the APEC economies adopt trade facilitation measures, US\$ 200 billion transaction costs will be saved. This will apply to the India-China FTA, too.

2. Investment

As mentioned earlier, the intended cooperation should be comprehensive, not only covering trade, but also in investment. It should create a transparent, liberal, competitive and facilitative investment regime. This will help improve the mutual direct investment between India and China. The formation of an India -China FTA should attract more investments into the region. More Indian and Chinese companies will be willing to invest within the integrated market, since market risk and uncertainty are minimized through the preferential arrangement.

After years of development, Chinese companies have become increasingly strong and competitive, and their overseas investments have grown fairly rapidly, especially since the mid-1990s. Their investment projects have ranged from purified salt, rubber products, pharmaceuticals, health-care products, food processing, household electrical appliances and forests products processing to petrochemicals, banking, insurance and shipping. The investment means has ranged from direct investment to technological investment and BOT. By June 2002, China has established 6758 non-financial overseas enterprises, investing about US\$ 10 billion. The top 12 Chinese Trans-national Companies (TNCs), mainly State-owned enterprises, now control over \$30 billion in foreign assets with over 20,000 foreign employees and \$33 billion in foreign sales in 2001². Although most of the non-state-owned enterprises are not very large in scale, they are also actively expanding abroad. These non-state-owned enterprises have investments in over 40 countries. In 2001, China's FDI outflows increased with an absolute value of US\$ 0.9 billion, reaching nearly US\$ 2 billion, ranking the 5th among the developing Asian and Pacific economies³. According to JETRO, China's FDI outflow surged 651.7% in 2001⁴.

² World Investment Report 2002

³ World Investment Report 2002

⁴ 2002 White Paper on International Trade and Foreign Direct Investment, JETRO

With China's further economic growth and industrial restructuring, Chinese companies' overseas investment is about to expand. In fact, investment abroad is encouraged by the Chinese government. More Chinese companies will invest in the neighboring Asian countries. India will be one of the priority markets for Chinese companies' overseas investment in the future due to the geographic closeness and its market size and potential.

Based on direct investment and the likely growing M&A's, the technology cooperation between India and China will broaden. After the formation of FTA, the enlarged market, intensified competition, increased investment and the expansion of production scale will force enterprises to invest more in research and development, hence promoting the technology innovation and enhancement.

3. Services

Today, services has accounted for 49% of India's GDP, but only 32% of China's. Such a contrast poses another aspect of future complementary cooperation. Liberalization of the services will yield greater economic benefits than liberalization of trade in goods, because protections of services are higher than trade in goods. Moreover, the spillover effect of services will help enlarge the economic gains. One example of cooperation is education. India offers a promising place for studies abroad for those Chinese students who are not able to go to the United States or Europe.

Undoubtedly, like the two sides of a coin, regional economic cooperation such as FTA will cause challenges to involving parties. However, it might be understood that the long-run benefits might be gained at the temporary expense of challenges.

Considering the economic development level, the priority fields for cooperation between India and China might be in information and communication technologies, small and

medium enterprises cooperation, energy, agriculture, environmental protection, human resources development, tourism and mutual investment.

India and China meet common opportunities and challenges in the dynamic world. The healthy and continuous economic growth is determined by whether one country can respond to the world economic trend in time and adjust its direction of development. Establishing a free trade area between the two sides to enhance bilateral relations would be a wise decision for the pursuit of new development opportunities.

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