

FOREIGN TRADE OF INDIA: TRADE CREATION AND TRADE DIVERSION IN REGIONAL ECONOMIC INTEGRATION AGREEMENTS

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ABSTRACT

Globalization is the origin of economic integration that gives rise to international business which includes under its purview all the commercial activities that take place for viewing, distributing, purchasing and consuming goods, services, technology, capital or knowledge across international boundaries. Simply put globalization means integration of national economy with the world economy. This research aims to identify and study the concept of international trade focusing on trade creation and trade diversion in Indian economy under the light of regional economic integration whilst emphasizing on Indian Free Trade Agreements (FTAs) radically for dynamic industries in which subject knowledge is continuously evolving.

Keywords: *Economic Integration, International Business, Free Trade Agreements, Indian Economy.*

Introduction

Dr. Salvatore defines international economic integration in very simple terms. He defines it as “the commercial policy of discriminatively reducing or eliminating trade barriers only among the nations joining together.” Economic integration, therefore, refers to a union made between countries in a geographical region aimed at lowering costs for both producers and consumers by decreasing investment and trade blockades and thus, freeing the flow of goods, services and factors of production.

There are five possible ways in which economies can integrate - The Free Trade Area, The Customs Union, Common Market, Economic Union and Political Union. This study focuses on Free Trade Agreements with respect to Indian Economy. FTA is a form of economic arrangement of countries within which tariffs and non-tariff barriers are eliminated but with no common trade policy for non-member countries. The concept of regional economic integration is the foundation of these trading agreements. According to the World Trade Organization, as on March 1, 2022, 354 Regional Trade Agreements (RTAs) are in force around the world of which India is part of 11 FTAs as stated by Ministry of Commerce and Industry.

Due advancement of economic integration agreements has given emergence to two trade effects namely Trade Creation and Trade Diversion. While Trade creation is the new flow of trade which does not exist without FTA and leads to cost saving and rise in consumption, Trade Diversion occurs when one's trade is directed from one country to the FTA's country and leads to increase in cost and loss in consumers. The study focuses on how both these patterns affect Indian Trade, their problems, gains and limitations.

Many of the studies have examined the concepts of Regionalism and Multilateralism arising due to FTAs and impact of these agreements. (Manoj Pant and Amit Sadhukan, 2009; Sejuti Jha, 2011; Asoke Kumar Mukherji, 2018) and there are numerous studies showing effects of trade creation and diversion of specific FTAs. (C Veeramani and Gordhan K Saini, 2010; Sumati Varma, Vikas Madhukar, Anoma Abhyaratne and Kanika Bankhad, 2017; Sonam Choudhry, Murali Kallummal and Poornima Varma, 2013). Most of the studies are either widely theoretical in nature or too numerically complex to be aware of by a layman. Most studies have used econometric approaches to analyze trade policies and the effects of creating and diversifying trade. This paper studies the impact of trade creation and trade diversion on regional economic integration with special reference to Indian FTAs in a made easy manner.

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Regionalism Vs. Multilateralism

Economic integration is the backbone of attaining benefits from trade. This is due to the fact that economic integration leads to high economic efficiency and rise in production through soaring trade and rise in capital flows and new technology leading to an increase in the overall wealth leading to an increase in giving escalating factor mobility and benefits from coordinated monetary and fiscal policies. Taking advantage of economies of scale and better resources leads to market expansion and aids member nations to diminish unemployment, income inequalities and poverty ultimately creating high possibilities of economic growth. It may open up to the possibility of less trade creation and more trade diversion. Many industries can be harmed and jobs be put in danger as economy is reconstructed. It may direct to oligopolistic collusion and improper assortment of resources. Thus, it can keep a nation from achieving high prospects. Economic integration is neither the foremost solution to the world's economic shortcomings nor it is the foremost source for them, but it is a highly contributing factor to sustainable growth, more income and eradication of poverty.

Regionalism was seen majorly after the Second World War. It is a concept that refers to the common sense of identity among the parties offering favorable trade arrangements to each other in comparison to the rest of the world by creating a regional trade agreement. In a multilateral trading arrangement, nondiscriminatory Most Favored Nation (MFN)¹ principle is the foundation upon which trade is based.

In contrast, multilateralism is a vast concept under which regionalism has crawled. The first paragraph of the first article of GATT has a prohibition against the use of preferential tariff rates but article XXIV of GATT permits such preferential trading agreements subject to the condition (a) among the members of the trade union all trade barriers are eliminated; (b) no higher or more restrictive trade barriers for non-members; and (c) interim arrangements leading to the free trade areas are employed for only a reasonable length of time. Thus, members of WTO can form regional agreements provided the above conditions satisfied. In the absence of regionalism, the geographical proximity would naturally lead to more trade, thus this framework has given a boost to trade and growth.

Traditionally, economies were perceived as distinct for each region or country, every country handling and looking over their own economy. With due course of time, there developed a remarkable interdependency within these economies. No economy functions as fully secluded from other economies in present times. Trade benefit for all economies is the core basis for such a situation. The adoption of regional and multilateral agreements has often put India through unique constraints. India has been targeting its multilateral trading goals and has engaged itself with trading partners but with a defensive outlook towards this new architecture of WTO. For India pursuing free trade agreements and expanding the scope of existing ones for liberalization of goods, services and investment can be favorable and affirmative or uncertain and imprecise.

India and International Trade

Conducting business across international borders has numerous benefits. India should be an advocate for international business. Being a developing nation, foreign trade can be a huge stepping stone in the direction of economic development. Additional foreign exchange earnings, market expansion and increase in investment are majorly the goals that every economy strives to achieve. In 2014, the Modi government came into power introducing *Make in India* as one of its major initiatives. Unemployment and GDP growth were the two factors that drove this initiative. In order to achieve this objective, regional integration needed to be an important part of foreign policy. In times when manufacturing is dependent upon cross border supply chains, India is expected to take lead in regional integration considering its location.

The Indian economy is going through a structural change. According to a study in 2018 by Asia Pacific Bulletin the Government of India feared that China would increase the roughly \$40 billion trade deficit and Indian businesses stood with the notion that they face high cost of production due to lack of structural reforms. In spite of the COVID-19 pandemic, many maintain high hopes from our economy. It can be validated through latest reports that cite that India would surpass Japan to become the second largest economy in Asia-Pacific region by 2030. The notion of once being considered as "second China" has been shattered in the last few years. Though a growth was witnessed when BJP took

¹ According to the principle of MFN which each contracting party to the WTO (formerly GATT) must grant to every other contracting party treatment as favorable as it gives to any other country.

office in 2014, it slowed down in 2017. The Indian economy had to face number of challenges with coronavirus and its variants and its impact thereon in the coming years. However India aims to realize a tremendous growth and surpass Japan in the given circumstances.

It is seemingly clear why opening up to international boundaries is of importance and why India should collaborate with other countries. India has not been just slacking off and doing nothing. Like any other developing country, India too has been negotiating trading agreements with a large number of developing nations and trade chains. India has been a bit late in this matter but is trying to cope up and magnify. India is a part of 11 FTAs and 6 PTAs (Preferential Trade Agreements) as on 8th December 2021 as enumerated in Table 1 and Table 2 respectively.

Table 1: Free Trade Agreements

S. No.	Name of the Agreement
1.	India-Sri Lanka Free Trade Agreement
2.	Agreement on South Asian Free Trade Area
3.	India-Nepal Treaty of Trade
4.	India-Bhutan Agreement on Trade, Commerce and Transit
5.	India-Thailand FTA - Early Harvest Scheme (EHS)
6.	India-Singapore Comprehensive Economic Cooperation Agreement
7.	India-ASEANFTA
8.	India-South Korea Comprehensive Economic Partnership Agreement
9.	India-Japan CEPA
10.	India-Malaysia CECA
11.	India-Mauritius Comprehensive Economic Cooperation and Partnership Agreement

Source: Ministry of Commerce & Industry

Table 2: Preferential Trade Agreements

S. No	Name of the Agreement
1.	Asia Pacific Trade Agreement (APTA)
2.	Global System of Trade Preferences (GSTP)
3.	SAARC Preferential Trading Agreement (SAPTA)
4.	India-Afghanistan PTA
5.	India – MERCOSUR PTA
6.	India – Chile PTA

Source: Ministry of Commerce & Industry

Government of India has issued Custom Rules (Administration of Rules of Origin under Trade Agreements) Rules, 2020 with effect from September 21, 2020 as there have been reported cases of re-routing of goods with the nations India has FTAs. These rules have put the responsibility on importers to be persistent in origin. These provisions ensure safety against misuse of trade agreements. An FTA monitoring committee has been formed representing government departments, trade and industry bodies to recognize the misuse of FTA provisions and take remedial measures.

Table 3: Indian Trade with FTA nations (Figures in US \$ Million)

Export/Import	2016-17	2017-18	2018-19	2019-20	2020-21
India's exports	59152.29	67576.95	73550.13	63515.49	63105.49
India's imports	65789.08	77692.17	93287.57	87327.72	74538.07

Source: Ministry of Commerce & Industry

Table 4: Total Indian Trade (Figures in US \$ Million)

Export/Import	2016-17	2017-18	2018-19	2019-20	2020-21
India's exports	275852.43	303526.16	330078.09	313361.04	291808.48
India's imports	384357.02	465580.98	514078.41	474709.27	394435.87

Source: Ministry of Commerce & Industry

With the due course of time India has rapidly expanded its market by being a runner at international trade for diversified products. Value of Indian trade with the partner nations and total value of trade is given in Table 3 and Table 4. India's exports to FTA nations has not performed very well. FTAs have surely led to an increase in India's imports and exports, but value of imports has been greater than exports. On comparing Table 3 and Table 4 we can see that the utilization of FTA trade is very low, only around 17% to 18% of total trade originates from FTA countries. Overlapping FTAs arise as a result of

their proliferation. Some believe that lower usage and minor inconsistencies are due to the mass of FTAs, while others emphasize that this may be due to trade orientation among nations. While the results may be undecided, the free trade agreement marketplace is important and must be given a chance to be exploited to see the full growth potential. The rising number of FTAs can lead to a huge shift in India's paradigm of imports and exports i.e. it can create more trade for India or it can divert it.

Trade Creation and Trade Diversion

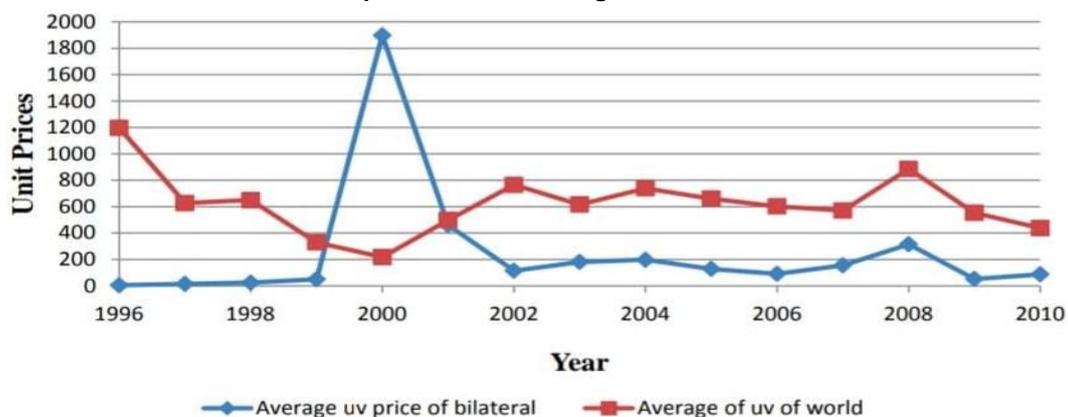
Trade Creation is the replacement of expensive locally produced goods within the country by inexpensive imports from more efficient confederate nations. Achieving the lowest possible price is the goal of any consumer and Trade Creation gives this goal a sense of completion. Trade creation leads to the production effect and the consumption effect.¹ Both of them together constitute the trade creation effect. However Economic Integration might lead to trade creation as well as trade diversion. While trade creation leads to welfare gains, trade diversion to welfare loss. The net welfare effect is the difference between welfare gains and losses. If trade creation is in the majority, the agreement is advantageous else disadvantageous.

Viner (1950) commenced the concepts of 'trade creation' and 'trade diversion' to describe the welfare connection of an RTA. *Meade* (1955) furthered the Vinerian framework allowing a space for change in international trade terms. *Gehrels* (1956-57) argued that Vinerian structure did not allow the probabilities of consumption changes after the formation of trade agreement. Later *Lipsey* (1957), *Johnson* (1974) and *Kirman* (1973) discussed whether or not the diversion of union trade can enhance the well-being of member countries. *Kemp and Wan* (1976) concluded that welfare of the non-members remains unchanged and increases world's well-being by existence of a common external tariff for an FTA. Advancements in the fresh theories of trade after 1975 opened wide range of welfare possibilities in diversified products and implications of these has been discussed by many researchers. Economies of scale, supply side effects, mutual recognition, fixed costs and many more such factors have been discussed in detail by numerous studies. Theoretical literature is inconclusive about the welfare implications of the FTAs on India, but many authors have empirically tested some hypothesis emerged in theory about Indian Trade.

FTAs' Implications with India as a Member

India's first free trade agreement with Sri Lanka, the India-Sri Lanka FTA (ISFTA) was signed in 1998 and became operational in 2000. As per the agreement both the countries settled on the need to protect internal sensitive industries. Overtime the two countries experienced sustained and growing trade. Both the countries benefitted from this alliance in terms of imports, Indian imports from Sri Lanka were increased and vice versa for various diversified products. [Mukherji et al (2002)].

Figure 1: Unit Value of imports of India from Sri-Lanka as Compared to the Rest of the World for Top 100 Trade Diverting Products



Export and import prices are shown as unit values and the year 2000 is considered as a set standard.

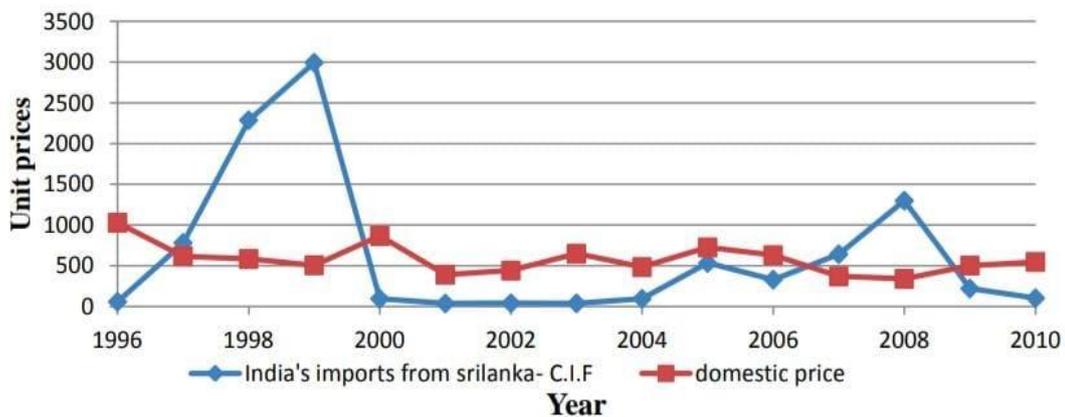
Data Source: WITS, Figure by: Centre for WTO studies, Indian Institute of Foreign Trade.

¹ The former occurs when imports replace domestic production and the latter occurs when there is high consumption of imported goods from partnered nations.

The above figure shows the unit value of imports of India from Sri-Lanka in comparison to the rest of the world. The average trade with Sri Lanka has decreased immensely after 2021 and the gap between imports from rest of the world and from Sri Lanka has increased respectively with passage of time. The formation of FTA lead to a decline in unit value of imports, Though the overall imports from Sri Lanka have increased since the year 1996. The decrease in unit value of imports can be attributed to the probability of trade diversion in favor of Sri Lanka and the fact that overall trade has improved with Sri Lanka for top 100.

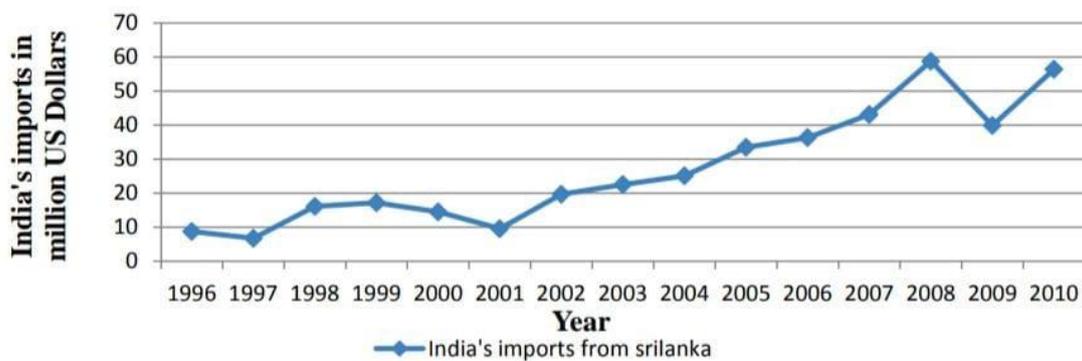
Figure 2 shows that the India’s export prices are taken as domestic prices. If domestic prices are greater than import prices, then Sri Lanka is said to have replaced the high domestically produced products. Figure 2 shows that domestic prices were higher for most of the time, consequentially, higher imports took place to reduce the cost. This indicates Trade creation as production cost is saved and consumption is increased which was not the case in domestic production. Figure 3 shows an upward trend in imports of top 100 trade creating commodities from Sri Lanka.

Figure 2: Unit Value of Top Trade Creating Commodities



Data Source: WITS, Figure by: Centre for WTO studies, Indian Institute of Foreign Trade.

Figure 3: India’s imports from Sri Lanka for Top 100 Trade Creating Products



Data Source: WITS, Figure by: Centre for WTO studies, Indian Institute of Foreign Trade

A research by studied Trade creation and Trade diversion effects in Indian economy by the formation of ISFTA by doing a sector wise analysis and concluded that both trade creation and trade diversion took place due to the formation of ISFTA as shown above but trade creation had more effect than trade diversion. [Sonam Choudhry, Murali Kallummal and Poornima Varma (2013)] As for other FTAs signed by India like India-ASEAN FTA there has been a continuous increase in trade growth. The growth imports is mostly depicted by trade creation than trade diversion. Though there was tariff revenue loss due to tariff reduction, there was a high rise in consumer surplus.

As for European Union-India FTA, ActionAid (2008) India imposed tariffs of most-favored nations on goods of 16 per cent with high tariffs (up to 160 per cent) on a small list of goods. This led to decline in the European market share showing the scope for trade diversion in favor of India. Further the low share of trade with European Union with low tariffs from European Union created the scope for trade creation. India's tariffs are quite high in European Union agreement, European Union may replace imports from India, resulting in trade diversion for India.

In most of the cases, trade creation has predominated trade diversion effects of which India is a part of, Since India has a huge trade market, in a bilateral deal India can increase in trade at the expense of domestic production creating a possibility of trade creation. High tariff protection is imposed by other nations an opening for trade diversion might get created.

FTAs' Implications with India as a Non-Member

Global trade comprises of wide range of commodities. If a commodity exported from India holds a relevant share in trade, then this commodity is considered as a very important factor for policy makers in terms of trade creation and trade diversion effects than the commodity whose share in trade is very low. In an article by *Mr. Manoj Pant and Mr. Amit Sadhukhan from Jawaharlal Nehru University* major commodities imported from India are considered to show income elasticity of demand as shown in Table 3. Globally there are numbers of FTAs with India as a non- member. For the purpose of this article we consider the following four FTAs:

Table 3: Income Elasticity of Demand for imports from India by Different Regions

FTA	Pre-Integration Income Elasticity	Post-Integration Income Elasticity
ASEAN	3.63	1.98
NAFTA	1.64	2.08
EU	1.53	2.28
MERCOSUR	2.86	3.70

Data Source and Figures by: Mr. Manoj Pant and Mr. Amit Sadhukhan, Jawaharlal Nehru University

From the above data we see that income elasticity of demand for Imports from India in case of ASEAN declined to 1.98 in post-integration period from 3.63 in pre-integration period. These income elasticities are at an aggregate level and the decline for ASEAN shows that there was likely a chance of trade diversion taking place on Indian exports. There was a rise of income elasticity in case of NAFTA, EU and MERCOSUR from pre-integration period to post integration period. For NAFTA elasticity increased from 1.64 to 2.08, for EU from 1.53 to 2.28 and for MERCOSUR from 2.86 to 3.70. This implied trade creation effects taking place. If we go into the details of each commodity sector wise, for some commodities trade creation was observed, for others trade diversion effects were observed and sometimes commodity wise breakup contradicted the results shown at an aggregate level so no unambiguous trade creation and trade diversion effects were observed.

There has been a proliferation of FTAs globally and many of these are developing nations. It is observed that India as a non-member remained unaffected by the formations of FTAs. India's decline in ASEAN exports were mainly due to demand constraints. India's overall trade improved in the post-integration period. This can be generalized by looking at the above four FTAs as well as various studies conducted. FTAs with India being a non-member of the agreement. Looking over the example of India, formation of FTAs did not seem to be a barricade for multilateralism.

Conclusion

In the last two decades, many trade patterns have emerged. With rise in economic competition among countries, effect of regionalism on multilateralism is an important factor that needs to be considered by the policy makers. Regionalism demonstrates high trade and liberates the movement of goods and services among nations by lowering of tariffs. Recently it was shown that multilateralism fails to provide the countries with tools they need to battle COVID-19 and regional cooperation was considered as a better approach. Even though some countries want to be isolated. The fear of strong trade diversion effects force them to be a part of regionalism. Free trade agreements allocate resources more efficiently, they seem to be a rational policy for a country. WTO has conflicting norms regarding this subject, but few economic reforms in "regionalism vs. multilateralism" matter may clear out some confusion that currently exists. Regional economic integration is extremely important, so India has remained wise and followed its own true interest, whether it benefits from multilateral trading system or from regionalism or from both and continues to do well in matters of trade.

India engaged itself into making many trade agreements with growth, mutual benefits and diversification being the major driving. The Indian Government announced a goal of export shipment target of US\$450-\$500 billion for the year 2022. Though several issues have to be ironed out for the same. We still have not seen a tremendous amount of growth in trade with the FTAs as expected. Imports and exports increased, but not up to their full potential. The percentage share of FTAs' growth in trade is very low. For India to achieve its target for 2022 more utilization of FTAs is required through better interaction and discussions with the members.

Trade creation and trade diversion are both an inevitable part of regional economic integration. As FTAs are formed, trade creation as well as trade diversion are bound to occur impacting Net welfare effect leading to welfare gain or welfare loss. Repetitively after studying about FTAs with India as a member and as a non-member, it is clear that Indian FTAs have been beneficial and have led to more of trade creation than trade diversion. FTAs with India as a non-member have shown that there is a scope for trade creation and trade diversion both. However, steps are being introduced to minimize trade diversion effects and strengthen the trade creation effects. In an article recently about India-UAE trade pact, Commerce Secretary vocalized that stringent value addition norms are being imposed to eliminate trade diversion. While India remains steadfast in its objective of achieving growth in trade in 2022, its aspirations of decreasing trade diversion and increasing trade creation may require it to recalibrate its approach into a more proactive one by tapping the full potential of FTAs.

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