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THEIR VIEW

The India-EFTA pact could be a game-changer as an FDI puller

Its investment aspect, a first, recognizes how foreign inflows are linked with world-trade success

MANOJ PANT
is a visiting professor at the department of economics, Shiv Nadar University.

In many ways, the recently concluded agreement between India and the European Free Trade Association (EFTA) is mainly a confidence building measure for India in the run-up to trade agreements likely to be pursued after general elections with the EU and UK. In most cases, the I-EFTA pact will have limited impact—India's principal import from the four-nation group, gold, is not subject to pre-determined tariff reductions, while agricultural imports are excluded. On the Swiss side, most tariffs are fairly low, so additional trade gains will be limited, except possibly in areas like textiles. Also, gold imports will continue as inputs for our principal exports to Switzerland (and the world) of gold and diamond jewellery. So, enormous gains in commodity trade with EFTA are not the plan. However, the tariff reductions agreed will certainly impact our UK and EU talks.

In services, some new ground may be expected, as there are hints of moving beyond the usual access bargaining for skilled Indian professionals, an area where some agreement seems to have been reached in pre-negotiations with the EU and UK. At this point of demographic change and ageing in most countries of the West, it is likely that such agreements will be swiftly signed with other countries as well; they need Indian professionals just as much as India needs to export surplus skilled labour. There is, however, a hint of the promotion of new aspects of trade in services, with a pact on establishing mutual recognition agreements (MRAs) in fields like nursing and education. How this proceeds is still to be seen, but if our history with Singapore is any guide, MRAs do not get too far until a prior agreement on a framework for the determination of MRAs is defined.

Where the I-EFTA deal truly breaks new ground is in its investment agreement. For one, it promises (mostly from the Swiss, I would think) $100 billion in foreign direct investment (FDI) with about half of it coming in the next 15 years. Unlike foreign portfolio investment (FPI), which is fickle and can depart easily, FDI indicates a commitment to bringing in technology and production. Given the expertise of the Swiss in engineering goods made by small and medium manufacturers, such a commitment is good news for India's beleaguered micro, small and medium enterprise (MSME) sector. It is empirically established that technology transfer takes place not through designs and drawings, but 'learning by doing.' Indian companies learn by working in collaboration with (or in the same industry as) technology leaders. The dominance of small Swiss companies is well known in clocks and watches.

Even more game-changing is the linking of investment commitments to India's tariff reduction plan. If, after 15 years, EFTA investment commitments do not materialize, then India may reverse its tariff reductions. This is surely a first in any agreement between any sets of countries.

Commentators often do not understand the close link between FDI and trade: they are two sides of the same coin. The transnational enterprises (TNEs) that bring in FDI actually bring in a combination of trade in commodities, services (managerial, etc) and technology (which may not be tangible). An almost one-to-one relationship between bilateral trade and FDI flows has been identified. Empirical work also shows that FDI and exports are complimentary in that over time, the foreign subsidiary adds to the host country's exports (*FDI in India: History, Policy and the Asian Perspective*, by Manoj Pant with Deepika Srivastava). Intuitively, about 80% of world trade (UNCTAD data) takes place between subsidiaries of TNEs. We call this 'supply chain trade.' The main point is that large FDI flows from countries like Switzerland can boost the export efforts of MSMEs, particularly by raising the quality of engineering goods.

The recognition accorded to this FDI-trade link by the EFTA agreement marks significant trade policy progress. However, as always, the devil lies in the details. For one, no FDI takes place till an investment agreement is in place. Some method of dispute settlement, definition of investment, etc, must be in place. There are few takers for the model agreement that India has been peddling. Work on this must begin afresh. Second, how will the volume of FDI be measured? Under current practice, the retained earnings of foreign subsidiaries (in proportion to the parent company's equity share) is also part of FDI flows. Will the Reserve Bank of India's measure of FDI be accepted? Third, the condition of 'reversal of tariff cuts' is surely in jest. Can we expect that after 15 years of trade with insufficient FDI, we will suddenly raise import tariffs on EFTA exports? One has rarely seen this happen. However, given the FDI-trade link, I doubt it will ever be needed. Its introduction was probably to ensure political acceptability.

With this I-EFTA pact, we may see a shift whereby European capital begins to use India as an export base as supply chains move out of China. Hopefully, these baby steps will be carried forward in the India-EU agreement. With technology inflows by means of FDI meeting India's large labour base, a shift of some Chinese trade with Europe to India could well become a reality.